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CONTAINER SHIP LEASING

Report by the UNCTAD secretariat

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Abbreviations

CMI Comité Maritime International

CERLA Comprehensive Environmental Response Compensation and Liability Act

CLC International Convention on Civil Liability for Oil Pollution Damage 1969

CTL constructive total loss

d.w.t. deadweight tonnage

FOC flag of convenience

g.r.t. gross register tonnage

P & I protection and indemnity

TEU twenty foot equivalent unit (container)

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INTRODUCTION

(i) In its resolution 36 (IX) II A, the Committee on Shipping requested the UNCTAD secretariat to prepare a study of the "advantages and disadvantages of leasing ... containerships."[1] It is not the first time that UNCTAD has taken up this subject.[2]

(ii) This report attempts to consolidate previous discussions held in various meetings within the United Nations system, and to provide a broad coverage of this subject without duplicating work already done. It includes in its scope a definition of ship leasing so as to differentiate it from other financing systems. The report also explores the history, and the legal, economic and practical aspects of leasing. Covered are not only the relatively short history and equally brief legal background related to this recently introduced and innovative method of financing large capital-intensive projects such as containerships, but also the obligations of the parties concerned, methods of operating under leasing regimes and publicly accepted proposals for improving shipping company operations under such regimes.

(iii) The UNIDROIT Convention on International Financial Leasing 1988 is discussed and its operation in, and effects on, containership leasing clarified.

(iv) As mentioned above, leasing has a short history with a fragmented and frequently neglected legal status, but its scope is international. The containerships being financed are large capital-intensive assets moving rapidly from country to country under various regimes, flags and conditions. This report attempts briefly to touch on all the common aspects, factors and problem areas involved or which may potentially become involved. The two main parties, those providing finance and those being financed, may be separated by distance and, occasionally, by completely different and sometimes conflicting juridicial and economic systems.

(v) One problem, or potential problem, is that despite the relatively brief existence of container shipping, the share of tonnage controlled by the developing economies is already declining. One reason for this may be the cost of vessels. Any method designed to ameliorate the situation will help developing countries. Leasing as a means of financing large capital projects is one obvious solution. Owing to space limitations in treating this subject, the general principles of leasing can be barely touched upon, their application to shipping in general only lightly covered, while those aspects more important to containership leasing will be discussed more comprehensively. However, the section on the financial industry is perforce brief.

(vi) It is important to note, however, that the impact of reduced external creditworthiness on the availability of leasing as a form of finance has not been dealt with, owing to the very different levels of creditworthiness among developing countries. In the case of a shipping enterprise from a developing country benefitting from favourable perceptions of creditworthiness, the considerations relevant to the leasing decisions may follow those described in the text. For an enterprise from a country suffering impaired creditworthiness, the availability of leasing financing may well be subject to constraints not covered in this report. Typically, in a country experiencing difficulties in relation to creditworthiness, foreign exchange is allocated on the basis of rules as to entitlements under the regime of exchange control. These rules can be expected to apply to payments of foreign exchange associated with a leasing contract, so that an increase in exposure to a borrower in the developing country on the part of the institution providing the finance will be subject to restrictions of the usual kind in such circumstances.

(vii) A more complete report is needed to cover such questions comprehensively and, owing to the speed at which conditions change, regular updating would be desirable. This report however does explain the general limits and scope of containership leasing with the aim of assisting developing countries.

(viii) Chapter I outlines the historical background of leasing, its particular characteristics, and the

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1 Decision 36 (IX), Annex II, A, 5 (g) of the Committee on Shipping.

2 See the ninth Session of the Committee on Shipping in 1978 (TD/B/C.4/179, pp. 6-7) and the eighth Session of the Committee on Shipping in 1977 (TD/B/C.4/161, p. 14).

specifics of ship leasing. In Chapter II the legal status of ship leasing is considered. The applicable legislative provisions are discussed along with the rights and obligations of the parties concerned. Contractual requirements and stipulations, as they apply to the lease and to the vessel being leased, are treated in depth giving full coverage to various alternatives. In Chapter III, the legal risks of both parties are considered and proposals are made for strengthening their positions and reducing risks where possible. Chapter IV discusses the merits and limitations of the UNIDROIT Convention on International Financial Leasing, adopted in 1988.

SUMMARY AND CONCLUSIONS

1. With the continuing spread of the containership concept into developing economies and into the most remote corners of the world, the need for developing countries to invest in containerships takes on increasing importance. It has been said, however, that "the shipowner makes his profit not through owning... but on the freight earned on the carriage. Ownership is seldom a prerequisite to profits and this salient point should be realised by the owner".[3]

A. Trade and containerships

2. In the past few years, container shipping has achieved the highest growth rate of all branches of the maritime industry. During 1980/85, container shipping expanded by an annual average of 8.0 per cent; in 1986/87, expansion averaged 8.8 per cent; in 1988 it had reached 9.0 per cent, and in 1989 the growth rate was 9.2 per cent. It is estimated that from 1990 to 2000 the world economy will grow at an annual average rate of 2.7 to 3.0 per cent, while worldwide containerized cargo volume will increase at an annual average rate of 4.7 to 5.8 per cent over the same period. Although obviously not the entire increase in world trade can be containerized, it is equally evident that the carriage of cargo in containers is penetrating trade routes and commodity trades not previously considered.

3. It has been estimated that by mid-1990 there were about 1,200 containerships totalling approximately 26 million d.w.t. in operation worldwide. Of these, approximately one third will need to be replaced before the end of the century. Thus, allowing for replacements and the growing containerized trade, some 25 million d.w.t. of ships with an overall capacity of 1.4 million TEU must be built. With many new-building yards already committed up to 1993, only about 5 million d.w.t. of 0.3 million TEU are expected to be built by 1995, leaving the estimated new-building requirement for the last five years of the present century at 20 million d.w.t. and 1.1 million TEU capacity.[4]

B. Ship financing

4. One of the most striking points in the world of sea transport is the infrequent use of the leasing concept. Leasing can often serve as a means of financing, especially when balance sheet ratios are lop-sided. Major leasing companies are present in almost every sector of the industry, except sea transport.[5] Ship leasing is probably under utilized because of the failure of potential lessees to understand how it can best be applied, the failure of the finance industry to understand the particular intricacies of the shipping industry, and the lack of standardisation of the equipment to be financed. In the airline industry, where there are only a limited number of commercial plane designs produced and the equipment range is therefore relatively standardized, leasing is the major financing system used worldwide. In shipping "it was containerisation which opened the door to the through transport concept by way of standardisation".[6] Containerships and their ancillary equipment are considerably standardized compared to other branches of the shipping industry, and therefore offer a more suitable basis on which to expand leasing arrangements.

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[3] J.O.E. Tan, "How to win in the container game - an analysis of the rules for starting a container shipping operation - including... the lease/buy decision", *Maritime Asia*, Hong Kong, May 1983, p. 24.

[4] "ISL Shipping Statistics Yearbook, 1990", Institute of Shipping Economics and Logistics, Bremen, quoted in *International Transport Journal*, No. 5, 1 February 1991, Rittmann, Basle, pp. 375-376.

[5] H. Langman, Member of the Board of Management, Algemene Bank Nederland n.v., Amsterdam, "*Financing Multimodal Sea Transport*", Amsterdam?, 1990.

[6] Tan, *op. cit.* p. 21.

5. Today, leasing of ships has gradually become accepted as an attractive alternative to traditional loan agreements in ship financing. At least this is so for those who understand leasing and has the related know-how. Unfortunately, there is no perfect legal system for financing the purchase or construction of a ship. Any advantages on the one hand are always counterbalanced by the risks or disadvantages, on the other. The particular benefits and drawbacks of financial leasing in the field of shipping are analyzed in this study.

6. It should be borne in mind that a shipowner looking for the most appropriate financing model must take into account various aspects before he makes his decision, e.g. his particular economic situation, including the corporate taxation regime to which he is subject, his market strategy and the availability of sufficient equity finance.[7] The legal and economic framework within which a shipowner may realise his commercial activities is only one aspect determining his action. A detailed exploration of economics-based aspects of ship leasing is beyond the scope of this discussion, although such an analysis would be worthwhile for a comprehensive appraisal of the advantages and disadvantages of leasing of containerships.

7. The importance of economic considerations is particularly obvious with respect to the tax aspects of leasing. Tax shelters were the main reason for financial leasing when this type of business commenced. In the United States, the leasing business grew out of so-called "tax-oriented" leasing which had been developed as a particular type of leasing contract.[8] Legislation on taxation in the United States[9] still offers particular tax benefits to the parties to leasing contracts. More recently, some countries have reduced the opportunities for tax advantages by changing their tax laws.[10] Thus, tax aspects have lost some of their overriding importance. A further look at this particular subject may be worthwhile for a comprehensive assessment of the importance of containership leasing.

8. Seaborne trade fluctuates according to the state of health of the world's economy. This factor has, on occasion, put a brake on ship leasing in the past and will no doubt continue to do so from time to time in the future. Although a lessor can protect himself against default by the lessee through appropriate clauses in the lease contract entitling him to repossess the vessel, there is no guarantee of finding alternative employment for it in a depressed shipping market. The lessee faces similar problems in terms of earnings in that a vessel leased during an upturn in business may have to be kept on-lease at great cost during a downturn. In comparison, shorter term charter rates follow the market, enabling charterers to earn income by employing the vessel at prevailing charter rates. In a severe or general downturn, the charterer can usually terminate a charter party and the corresponding charter hire with relative ease, although at some expense. Ship leasing is therefore not a sensible option for providing marginal traffic capacity. Even based on reliable cargo traffic, the lessee must consider the possibility of a severe economic downturn when the lease obligation will continue until the expiry date, whereas an owned vessel could be disposed of, albeit probably on unfavourable terms.

9. The extent of volatility in the shipping market, unpredictability of demand, and consequent fluctuation in charter rates may be looked at in terms of comparable air and sea traffic fluctuations over the 10 years from 1980 to 1989. During this period, worldwide air traffic increased annually from 2 to 10 per cent over the previous year, i.e. fluctuating by 8 per cent, for an average annual increase of 6.2 per cent.[11] During the same decade, worldwide seaborne trade decreased in five of the years, from 2 to 14 per cent annually but also increased over the other five years, from 3 to 7 per cent annually, for an overall average reduction of 0.7 per cent, that is remaining almost unchanged, despite a fluctuation

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7 P. Slater, "The Need for Equity Finance", *Ship Finance*, New York Seminar 28-30 October 1980, (hereafter called the "New York Seminar"), Seatrade Academy, Cambridge, n.d. (1980).

8 P.K. Nevitt, "Leasing in the United States", *Leasing for European Shipowners*, Seatrade London Seminar, 18 September 1973 (hereafter called the "London Seminar"), Seatrade Publications, Colchester, n.d. (1973), pp. 41-59.

9 Under the 1981 United States Economy Recovery Tax Act, special tax advantages are granted for leasing transactions; see J.M. Clark, "The Dawn of International Leasing", *The Banker*, Vol. 132, No. 674, London, April 1982), pp. 69-75. Furthermore, leasing can be used to reduce the difference between a company's financial and tax accounts. Since a 20 per cent tax rate is assessed on half of that difference (AIM provision), leasing can be an attractive instrument to reduce this tax. See *The Lease Versus Buy Decision for Container Equipment*, Temple Barker and Sloane Inc., Lexington, Mass, September 1987, p. 13.

10 The tax law of the Federal Republic of Germany is a significant example. In 1970 general guidelines for the treatment of leasing in tax law were published by the Bundesfinanzhof (the highest authority in tax matters), [Decision of 26.01.1970, published in: *Der Betrieb-Berater*, Vol. 23, No. 25, pp. 972-979.] Later a highly sophisticated system was developed for the treatment of the various types of leasing transaction. Today, as a result of these activities, tax aspects no longer dominate but still remain of interest in leasing in Germany. See: A. Boobsin, *Leasing im Steuerrecht*, 2nd ed., Forkel, Wiesbaden, 1985.

11 In tons per kilometre, Langman, *op. cit.*, Source: ICAO, ILA.

swing of 21 per cent, (from -14 to +7 per cent).[12] This massive see-sawing of demand for shipping space reveals the volatility of the industry.

10. The poor performance of banks in the 1980s that has persisted into the 1990s, along with the continuation of bad debt problems, are cause for concern to all ship operators, as the recessionary effect builds up. One obvious option for banks to take would be to improve their capital ratios and reduce lending. This will particularly affect capital-intensive investments such as containerships. Traditional sources of finance may well prove difficult to draw on for some years. As the banks' problems are worldwide, even spreading the risk through syndication may not work.[13] While the banks' problems have been general, those with the greatest commitment in the shipping sector were involved in the massive over-building of the 1970s and early 1980s and then suffered the shipping collapse of the 1980s when freight rates often bore no relation to real economics. This forced shipowners to rely on speculative gains in ship values instead of trading profits. This process is now at an end. However, "The industry is only left with old ships, having prolonged the commercial worth of many ships through speculative asset trading, but with rates too low to build new ones... . The huge rise in sea transport costs will come as a result of the need for fleet replacement during the 1990s... . Leasing has double attractions: it brings in money for a fleet now in clear need of replacement but without need to start another cycle of speculation."[14] In fact leasing offers two more attractions: the ship operator now without funds is enabled to renew his fleet without up-front cash; the financier, by retaining formal ownership through leasing, can prevent the operator from short-term asset selling and assist him into long-term trading, leading the way to recovery in a stable pattern.

11. The question of reduced external creditworthiness mentioned in the introduction can be illustrated with two hypothetical cases. In both, the purchase of the ship involves an outlay of currency other than that of the country of the shipping company (the lessee). In the first case the lessor is a foreign financial institution (which might be a wholly-owned subsidiary of a major international bank). In this instance the lessee's rental payments to the lessor would be in the form of foreign exchange made available under exchange control in the lessee's country. In the second case, the lessor is an institution in the country of the shipping company and finances the purchase of the ship with a loan from an international bank. In this example the lessee's rental may be in the form of payment in local currency to the lessor. However, the lessor must still make payments of foreign exchange to the international bank in order to meet debt-service obligations and such payments must be authorized under the country's foreign exchange control rules. In both cases the availability of financing for the leasing transaction will be subject to international bank guidelines for handling the risk of non-payment for the country in question.

12. In one developing economy, a ship-leasing programme as official policy appears to be working successfully. After a slow start some years ago, in 1991 the state-owned leasing company had awarded contracts to local yards to build an initial group of 24 geared containerships and semi-containerships under 20 year leases, payable in local soft currency for local shipowners in domestic and international trades under the national flag.[15] Assuming this activity continues according to plan and that the vessels operate effectively for their lessees, this is a fine example of the potential use of this financing method for the maximum benefit of a developing economy.

13. In another developing country, new ship-building orders in 1990 included 400,000 g.r.t. financed by leasing. This totalled USD500 million in lease contracts for local owners with local banks. The banks obtained most of their funds for this overseas development in the world market.[16] This country is following the traditional leasing systems of developed economies.

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[12] In tons per mile, Langman, *op. cit.* Source: *Maritime Transport 1990*, OECD. In fact, over the five years 1981-1985, the annual changes were: -6, -14, -7, +6, -2 per cent respectively, an even more volatile short period.

[13] Lothbury, "Bankers Diary", *Fairplay*, Coulsdon, 31.01.1991, p. 8.

[14] K. Chinnery, "Finance, Leasing - The Golden Triangle", *Lloyd's Maritime Asia*, Hong Kong, January 1991, an interview with P. Slater of First International Leasing Corporation, pp. 8-9.

[15] T. Lim, "Small ships in Asia", *Lloyd's Maritime Asia*, Hong Kong, April 1991, p. 13.

[16] *Seatrade Week*, New York, 19-25 April 1991, p. 10.

C. Advantages and disadvantages of ship leasing

14. The analysis shows that ship leasing can serve as an alternative form of ship financing. Both lessors and lessees can benefit from the particular characteristics of leasing transactions in shipping. However, financiers and shipping companies, i.e. potential lessors and lessees, should always bear in mind that ship leasing as one alternative to traditional loan agreements also carries particular risks for the parties involved. In the following paragraphs typical advantages and disadvantages are given from the perspectives of both lessor and lessee.

15. Containership leasing presents certain advantages for the trade of developing countries. Operators established in developing countries who finance the use of containerships through leasing will pay rental out of their revenue. Consequently, the overall cost of the transaction when finance is provided by foreign institutions will not affect the country's capital debt balance sheet, a feature which may be regarded as an advantage for the country concerned.

16. Of particular interest for containership operators is that leasing with minimal difficulty can include equipment from more than one supplier under just one agreement. When obtaining a containership, the operator usually plans to enter a new trade or to replace conventional or smaller ships and may consequently need a supply of containers. Similarly, containership operators often find it advantageous to "own" shore equipment at some ports because of a shortage of such facilities or may wish to supplement those available to maximize his profits. Thus, a container crane, straddle carrier, fork lift, etc., may be occasionally required by the operator along with his base of containers and ships. Compared to other financial arrangements, it is easier to group this equipment and the container ship(s) from different suppliers and even in different currencies, within one financial lease arrangement. This simplification considerably eases the cost and calculations of payments for the lessee and enhances the quantum of the lease for the lessor.

17. "Financial and operating leasing has become a principal vehicle for financing capital equipment [such as containerships and container equipment] acquisition in many of the industrialized countries within a short 20-year period. Utilization of the leasing concept in developing countries, however, is not as common and has been inhibited by a number of factors, including:

(a) legal factors (e.g. the legal system of the developing country may not recognize the special nature of the modern equipment lease and may treat the lease as a traditional rental of property and thus place inappropriate responsibility on the lessor);

(b) tax or revenue factors (e.g. the tax system of either the lessee's or the lessor's home country may not allow the lessor to take sufficient advantage of the tax benefits of equipment ownership);

(c) practical factors (e.g. the lessor may perceive a high risk in terms of his ability to inspect or repossess the leased property in a developing country); and

(d) contractual factors (e.g. the terms of the typical financial lease provide that the lessee may not cancel the lease and thus all risk as to the suitability of the leased property is borne by the lessee.)

These factors must be considered in order to prevent the lease method from producing undesirable results such as higher ultimate costs to the lessee and limitations on technology transfer."[17] That being said, consideration of this means of financing high-cost, long-term operating equipment such as containerships does not yet appear to be well known nor understood in many developing economies.

D. The lessor's view

18. From a creditor's point of view, the main advantages of ship leasing may be summarized as follows:

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[17] *"Analysis of Equipment Leasing Contracts"* United Nations Centre on Transnational Corporations, New York, 1984, (hereafter called the "United Nations Analysis"), page 5.

(a) A lessor, by definition, retains ownership, thus leasing affords the financier (lessor) better security than a mortgage. In particular, the legal procedure to enforce a ship mortgage (i.e. hire purchase wherein the ownership is transferred to the buyer from the beginning) is to repossess the property, usually a much more difficult and costly procedure than a claim filed by the owner to repossess his vessel;

(b) Under some jurisdictions, a lessor may obtain tax advantages (investment tax credit) which are not available for a creditor granting a normal loan to a debtor. This is so particularly in the United States, the United Kingdom, and some other countries;

(c) The risks usually borne by a shipowner rest entirely with the lessee under a ship-leasing contract. Thus the lessor retains the benefits of ownership without most of the responsibilities;

(d) The lease rental continues to be payable by the lessee even if the vessel is out of operation; and

(e) The lessor enjoys very effective remedies against a lessee's default.

19. However, a financier has to take into account that he also faces risks under a ship-leasing agreement, namely:

(a) As the owner of the vessel, he may be held liable in tort for damage caused by the vessel to third parties;

(b) Since various claims arising out of the contractual liability of the lessee may give rise to maritime liens or to a right to proceed against the vessel in an action *in rem*, the lessor's interests may be affected by those claims, although he does not himself have any contractual relationships with any creditors of the lessee;

(c) Under some jurisdictions it may be difficult for a lessor to enforce his ownership rights if the lessee goes into bankruptcy; or

(d) The lack of unified legal principles for ship leasing in international law particularly hampers the growth of "cross-border-leasing". Although ship-leasing contracts are covered by the scope of application of the "UNIDROIT Leasing Convention 1988", in practice the Convention fails to improve this situation.

E. The lessee's view

20. For various reasons a shipping company may lease a vessel instead of buying it. Usually such a decision depends on the particular commercial needs and the economic situation of the ship operator. In general, the main advantages for the lessee can be summarized as follows:

(a) Ship leasing provides a shipping company with the entire possession and use of a vessel without capital outlay. Under traditional ship financing, the shipping company is usually obliged to pay at least 20 per cent of the purchase price as down payment;

(b) "The decision on whether or not a company can profitably buy... must be based not only on whether or not funds are available, but more importantly, on the loss of opportunity caused by using available funds that might have been used for improving marketing, opening new facilities, or the expansion of [business] potential;"[18]

(c) Moreover, the payment of lease hire can be financed out of the earnings of the vessel during its operation (cash flow advantages);

(d) A ship-leasing transaction has no impact on the lessee's credit balance. Consequently, ship leasing increases the overall credit raising capacity of the lessee;

(e) Since possible tax benefits granted to the lessor are partly passed to the lessee owing to

[18] B. Pickering, quoted in "Why do people bother with depreciating assets", *Lloyd's List*, London, n.d.

normal competitive commercial practice, ship leasing may be more economical than traditional ship financing. This is particularly so when the lessee cannot take full advantage of capital allowances because of a lack of sufficient corporate taxable profits, a situation not infrequent in the shipping industry;

(f) Under some jurisdictions, other additional tax advantages are granted to the lessee (e.g. rentals can be written off at a faster rate than depreciation of assets);

(g) Since the lease hire is usually calculated at a fixed rate, leasing may serve as a hedge against inflation;

(h) The stipulations of a ship-leasing contract can be tailored to the particular needs of the parties. "An ... advantage of leasing is that it is a very flexible financial tool and it can be designed to cope with many differing situations and requirements."[19] In fact owing to the "big ticket" nature of a ship, and the various different international situations in which the operator may intend to use it, the finance arrangements are usually specifically tailored to each individual case: "The golden rule is that there is no golden rule; every case is an individual case and the lease is tailor-made to fit that particular case;"[20]

(i) The possibility of bareboat registration, offered under some jurisdictions, enables the lessee to operate the vessel under a different flag (registration) from its original flag of registry. Often it may be the country of the lessee, who chooses it as the location of his permanent business, either to satisfy his national interests, or to be eligible for domestic advantages (e.g. tax savings, cargo priority, political or commercial goodwill, etc.). Sometimes he utilises a flag of convenience (FOC) for financial advantages (reduced costs, less restrictive laws, etc.). Occasionally he will choose a fourth-flag country (not the owner's, not the lessee's, not one of the well-known list of recognized FOC's, but another country, usually for a planned commercial advantage). Such a bareboat arrangement enables him to avoid the problems of changing the registry of the vessel (obtaining the approval of the mortgagees, etc.);

(j) A shipowner wishing to release capital to purchase additional tonnage or invest elsewhere can enter into a "sale and charter back" agreement with certain financial institutions. It is becoming more common for operators, upon completing payments and becoming owners of a vessel which they wish to keep, to sell it and charter (lease) it back, thereby obtaining cash for alternate investment; and

(k) It is usually possible to set up a leasing transaction in less time than is required to arrange an outright purchase, thus avoiding the relatively high cost of establishing a mortgage.

21. Ship leasing should not be considered a perfect alternative for acquiring a vessel. The lessee also faces various problems under a ship-leasing transaction:

(a) Since the lessee is not the owner of the vessel, he is not entitled to sell the ship even if he could obtain a profit from such a sale;

(b) The lessee is not entitled to terminate the normal ship-leasing contract during the contracted term;

(c) Any delay in payment of lease hire can result in very harsh legal consequences for the lessee;

(d) The risks usually faced by a shipowner rest entirely with the lessee, although he is not the owner of the vessel;

(e) The lessee bears the complete risk of employment of the vessel. The lease hire continues to be payable, even if the ship cannot be operated for whatever reason;

(f) The nebulous and fragmented nature of domestic laws on ship leasing as well as the lack of a unified international legal framework lead to uncertainty of law; moreover, owing to its relatively recent introduction, there is often little legal precedent to follow;

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19 G.V. Ryan, "Case Study of a Ship Leasing Deal", *London Seminar*, op. cit., p. 1.

20 *Ibid.*, p. 10.

(g) Because the lessor usually relies heavily on tax advantages in setting the overall cost of the contract, and consequently the rental level, it is not uncommon to encounter what is termed a "claw back" provision entitling the lessor to increase rentals if the tax advantage is lost through changes in the law or in the status of either party; or

(h) In the case of older vessels with a shorter and less certain profitable lifespan remaining, the lessee may be taking on a long-term commitment to repay at a cost which could become untenable.

F. Conclusions

22. A comparison of the various advantages and disadvantages shows that ship leasing cannot serve as a general solution to all problems concerning ship financing. However, it is one possible way of meeting the financial requirements for the acquisition of vessels. Tax benefits and flag advantages can be combined with the financial needs of shipping companies by leasing a vessel instead of buying it. Ship leasing can be a particularly attractive alternative where the financial requirements of large capital projects and shortages of equity finance prevent shipowners from obtaining access to traditional loan financing. The increasing building costs of properly equipped modern vessels in container shipping, on the one hand, and the permanent shortage of sufficient capital in many developing countries, on the other, make ship leasing an attractive instrument to solve financial and commercial problems of shipping in those countries. A practical and workable internationally unified legal framework is urgently needed to remove the existing uncertainty of law, but there is presently no sign of one on the horizon. Nevertheless, containership leasing presents an important opportunity for developing economies to invest in this type of capital-intensive business, whether more traditional financing methods are available or not.

CHAPTER I

LEASING - AN ALTERNATIVE IN SHIP FINANCING

23. Leasing is a relatively recent method of financing. For this reason and because of its attractive features, it has been introduced in different forms into many branches of finance worldwide. Thus its definition is elastic. Its use differs in various countries and fields of finance. This report covers the application of ship leasing in those countries where the industry is most developed.

A. Historical background

24. There are differing means available to shipowners to meet capital requirements to finance the construction or purchase of a vessel. Usually a shipping enterprise does not wish, or is unable, to finance a ship purchase completely out of its own reserves. Under traditional ship-building contracts, the buyer meets the capital requirements by arranging financing with a third party through a loan or by an instalment purchase where the shipyard may finance a portion of the construction price. In both cases, the shipowner becomes the owner of the vessel after delivery, just as in any other hire-purchase arrangement. However, he has to pay interest for the credit granted by the shipyard or bank under the loan agreement. These conventional financing methods may require a substantial outlay of "up front" capital by the shipping company. This is particularly true as far as containership services are concerned. The technical developments in container transport and an improved standard in the technical equipment of those vessels have vastly increased on building costs. In addition, the speed of technological developments places shipowners under permanent pressure to modernize their fleets. Nevertheless, the obligations under a conventional loan contract must be met by the shipping companies even if the vessel, financed by such a loan, is no longer operated by the shipping company. As a consequence, new systems have been created in international ship financing and in the early 1970s financial leasing was introduced into shipping.[21]

25. As a new type of commercial and general financial contract, leasing was pioneered in the United States at the beginning of the 1950s. The first independent leasing company, "the United States Leasing Corporation," was incorporated in the United States in 1952.[22] Since it proved successful, leasing spread to Europe and Japan. In 1960 the "Mercantile Leasing Company" was founded in the United Kingdom,[23] and in 1962 the Hambros Merchant Bank established the "Equipment Lease Company".[24] In 1973, the "European Federation of Equipment Leasing Company Associations (Leaseurope)", a consortium representing 80 per cent of the financial leasing industry in Europe, was incorporated under Belgian law.[25] It was at this time that the international shipping community took an active interest in leasing. Nevertheless, today the leasing industry of the United States still represents half of the total world leasing by value of finance provided.[26]

26. In recent years, the most successful application of the leasing system of financing ships, particularly second-hand tonnage, is the Norwegian "K/S system" *(kommandittselskap)*, or limited partnership scheme. This description also covers the similar, but more conservatively operated, Danish system. Since ship ownership and operation being a traditional industry in these seafaring nations, with closely knit shipping and financial communities, there has been long-standing favourable legislation to allow entrepreneurial ship operations to prosper. This system is not new, nor is it confined to shipping. The basic taxation system under which it operates has not changed since the 1920s, although the rules

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21 Nevitt, *op. cit.*, p. 41.

22 *United Nations Analysis, op. cit.*, para. 29.

23 *Idem.*

24 *Idem.*

25 *Ibid*, para. 121.

26 D. Porter, "The Benefits of a Strong Leasing Industry", *World Leasing Yearbook*, Coggeshall, Hawkins, 1989, (hereafter called "World Leasing"), p. 13.

have been tightened in some respects.[27]

27. Unlike leasing, the K/S system is really a linking series of localized financial and taxation advantages driven by market conditions. While ship-owning conditions have long been favourable for the traditional national owners, the K/S system has only accelerated with the market rise in second-hand vessel values since 1986. Although generally described as a tax-oriented leasing system, it is in fact the tax relationship to profits from asset sales that is the benefit of this scheme to local partnerships. For this reason, it is attractive in a rising market and in such a market, in a volatile industry like shipping, it is most attractive for older vessels, particularly tankers, as this combination tends to have value fluctuations proportionately more than younger and other types of vessels. Under the K/S system, each ship is owned by a separate company and when extraordinary expenses occur there is no other income into the owning company from which to draw funds. In this case the shareholders must provide such funds at short notice. By 1990, costly pollution incidents, technical breakdowns and casualties often associated with the age of the ships operated under this system, have caused a ship safety crack-down which, together with proposed Norwegian tax reforms and a coincidental downturn in the second-hand ship values in 1990, have led to a dramatic fall in new K/S projects. This has entrained a switch in emphasis back to more traditional forms of ship finance and investment.[28]

28. Despite this, as of January 1991, there remained 188 tankers and bulk carriers with an average age of 13 years (average size 62,000 d.w.t.; average value $US 13.4 million) in the K/S fleet. These statistics are almost identical to total world averages for the same classes of vessels. Thus while still concentrating on the more volatile, unpredictably priced and older types of vessels in the shipping market, the K/S fleet has now settled into a more reasonable investment vehicle for those selecting this type of risk.[29]

29. However, "if proposed tax reforms currently before the Norwegian Government go through parliament, Norwegian shipowners face a ten-fold increase in tax."[30] This has been heralded as "the end of the K/S system."[31] Thus, in the near future, either the sudden demise of this system or, at best, the slower abandonment of this peculiarly Scandinavian method of financing ships can be expected.

30. Even though leasing has expanded more slowly in developing economies, it is now becoming firmly established. The continuing development of leasing in Asia serves as an example. Considerable growth rates were reported for Indonesia (85 per cent), Korea (40 per cent) and Taiwan Province of China (28 per cent) in 1987.[32] Several leasing companies are also located in Africa.[33] It is felt that leasing offers some advantages which, in particular, serve the special needs of many companies in those countries.

B. The characteristics of leasing

31. It is not possible to give a general definition of leasing, since various forms have been developed during the past three decades tailored to the particular purpose of the leasing transaction.[34] However, the differentiation between use and ownership remains the fundamental characteristic of all forms of leasing.

32. It is necessary to distinguish between the so-called "operating lease" and the "financial lease". Operating leases are usually used on a relatively short-term basis to overcome a temporary shortage of equipment. Consequently, an operating lease is normally, but not always, a "non-payout lease". In other words, the lease hire is not calculated to cover the lessor's costs for purchasing the leased equipment and all other expenses incurred by the lessor, plus a profit, etc. The leased property is not fully amortized during any single lease period and still has a particular value after the first lease agreement

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27 I. Middleton, "Analysis", *Seatrade Business Review*, London, September/October 1990, p. 21.

28 See: *Lloyd's Shipping Economist*, London, August 1990, p. 10.

29 Clarkson Research Studies Ltd., "The Clarkson Bulk Shipping Review", London, Spring 1991, quoted in *Fairplay*, Coulsdon, 11 April 1991, p. 14.

30 "Norwegian Owners face tax blow," *Fairplay*, Coulsdon, 18 April 1991, p. 5.

31 "Taxing times", *ibid.*, p. 2.

32 A. Hornbrook, "A Decade of Global Growth and Sophistication", *World Leasing*, *op. cit.*, p. 11.

33 The growth of the leasing business in Nigeria is one example. See statistics in *World Leasing*, *op. cit.*, p. 230.

34 For a review of the various forms of leasing contracts, see: *United Nations Analyses*, *op. cit.*, para. 14-28.

expires. Equipment leased under operating leases is intended to be the subject of several successive leasing contracts. From a legal point of view, the right of either party to cancel the leasing contract is usually considered to be the characteristic feature of an operating lease. As the intention is not to recover the whole value, it is of little legal consequence, provided a pre-contracted or negotiated penalty is paid by the lessee to the lessor. Shipping container rental is the most obvious example of an operating lease.

33. Financial leasing is normally long-term leasing, where the lessee is not entitled to cancel the contract.[35] Moreover, a financial lease is usually constructed as a "full-payout lease". The lease hire is calculated to cover the lessor's cost for the purchase of the leased equipment, any additional expenses, and his profit. Financial leasing can also be described as a special form of granting a credit. Under conventional loan agreements, the financier grants money to the borrower, but the credit under a financial lease has the shape of equipment granted to the lessee, instead of its actual money value. Financial leasing transactions usually have the following characteristics:[36]

(a) The equipment is for business or professional purposes;
(b) The specifications and choice of the equipment lie with the lessee;
(c) The supplier of the equipment purchased by the lessor is selected by the lessee;
(d) The lessor remains the owner of the equipment;
(e) The risks usually borne by an owner of equipment are channeled to the lessee (employment, destruction, impairment, etc.);
(f) Any remedies of the lessor arising out of imperfect performance of the supply contract are assigned to the lessee, and
(g) In return for this assignment, claims by the lessee against the owner (lessor) resulting from defects of the equipment are contractually excluded. (The lessee must claim against the seller but with a weaker case than if he were the owner (buyer) himself.)

34. Sometimes parties agree upon:

(a) A purchase option for the lessee at the end of the lease; or
(b) A sharing of the proceeds of a sale of the leased equipment after the lease has expired; or
(c) A second lease at discounted levels after expiry of the original lease.

35. However, it should be borne in mind that under some jurisdictions (e.g. Germany, United Kingdom), contracts including a purchase option are not regarded by law as a lease but an instalment sale or a hire-purchase agreement. "[Tax-oriented financial] leases in the United Kingdom must not involve a purchase option running in favour of the lessee. Such an option results in the transaction being classified as a 'hire-purchase' and the lessee is deemed to be the owner of the property. The capital allowance [tax advantage] is then shifted from the lessor to the lessee."[37] While it may not be technically correct to say there cannot legally be a purchase option clause in a financial lease contract, for all intents and purposes such a clause in these circumstances offers nothing to either party. The situation is similar in the United States. As a consequence, tax advantages are not granted for those types of contracts. In other countries (e.g. France) the existence of such an option is a requirement for classifying the contract as a lease (*crédit bail*). In France a full-payout lease involves obligatory (absolute and unconditional) payments by the lessee to the lessor that exceed the purchase price and the financial costs.[38]

36. Leveraged leasing is a specialized form of financial leasing. It conforms with the characteristics, as described, for financial leases in general and serves the same purpose for the lessee; however, its structure and documentation on the lessor's side can be extremely complicated. It magnifies the tax shelter capacity for the lessor but simultaneously broadens overall lessor risk while sharing this risk among others.[39] This is explained in more detail below.

37. Some combinations of lessors/lessees, laws/jurisdictions, tax situations, etc., may not be suitable for realizing tax benefits that are available in others. This is often the case in cross-border combina-

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[35] United States laws specifically allow under certain circumstances for aircraft leases to be "... voluntarily terminated... so long as no event of default shall have occurred and be continuing ...". *United Nations Analysis, op. cit.*, para. 140.

[36] *Ibid.*, para. 20.

[37] *Ibid.*, para. 47.

[38] *Ibid.*, para. 19, 29-65, & 66-114. For a comparison of the national legislation, see: J. Monken *Der Finanzierungsleasingvertrag über bewegliche Sachen im kaufmännischen Verkehr*, (Florentz) Verlag, Munich, 1989.

[39] Nevitt, *op. cit.* p.44.

tions. The result is that lease rentals would be higher than in situations where savings are available. Despite this, there are frequently enough attractions in what becomes a "non-tax-oriented financial lease" to consumate a transaction. Being free of government taxation or internal revenue department supervision enables more freedom of action by the lessor. Without having any first year or similar early tax deductions, for which he is answerable to the tax authorities for the duration of the benefit, the lessor can more easily agree to the inclusion of early sales rights during the life of the lease, and can certainly more easily calculate buy-out costs. Under such circumstances one option has been given as follows:

> "Should a lessee wish to dispose of the vessel during the term of the lease, we can offer him alternatives. Firstly, he could find us another acceptable lessee or, secondly, he could ask us to sell the vessel, in which case there would be an appropriate balancing charge, depending upon how far through the lease term the ship was sold. All proceeds from the sale over and above the balancing charge would be for lessee's account."[40]

38. There are similar compensating benefits available at the completion of the lease period. In the United Kingdom, for instance, under those conditions where the lessee's purchase of the paid-out vessel under a tax oriented lease is severely restricted, when tax benefits have not been gained under certain circumstances, it is possible to build into the lease a pre-negotiated purchase price option for the vessel at the successful completion of the lease. As the lessor is not in the shipping business and has already obtained his full costs and profits, he may be amenable to a sale price below the lessee's estimate of the current market price, or may offer a second lease at reduced rates. As one proponent has put it: "the operator or lessee may either elect to continue the lease at a peppercorn rental or buy the vessel himself for a previously agreed amount".[41] Another has said: "as the cost of ships soars, the residual – that is, the value after the fixed term, or the profit on the actual cost of the ship – is becoming of greater and greater importance. The lessor would, of course, like to retain the whole of the residual but the lessee will equally want it and it is a question of the negotiating strength of the parties which dictates where they end up. It is now normal to give the lessee a number of options. There are no hard and fast rules..."[42]

39. More recently this situation has been described as follows: "If the lease contains no provisions preventing the lessee from arranging for the sale and disposal of, or materially altering, the lease property then the lessee may find himself 'frozen in'... While lessors will rarely have any reason to object to the lessee's arranging the sale or disposal of the leased property as long as he continues to meet his financial responsibilities to the lessor, the lease should contain terms specifically addressing this point."[43] This then gives the lessee the opportunity to purchase an asset that will enhance his balance sheet at a very attractive price, to obtain a capital gain from its sale, or to continue trading the vessel at a much reduced level of overhead cost.

40. A United Kingdom owner, and one of the world's largest owners of containerships and other capital-intensive vessels such as cruise liners, has for a number of years leased some of its containerships. However, it has recently completed a package deal of a selected number of the more capital-intensive units of its fleet (said to include 33 ships in the package), some of the most recent not yet delivered from the builders, and at least one over 20 years of age, for sale and leaseback to a group of competing finance houses. It was described by the company as "a financial mechanism" and is explained by saying, "insufficient profit is realized from vessels to make use of all the tax allowances which are generated" so "selling a ship to a finance company allows advantage to be taken of the tax benefits of writedowns against profits". In this instance the leases are said to be for the lifetimes of the vessels.[44] This avoids any potential problems of buyback or second leasing once the original lease has been completed.

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40. Wallis, *op. cit.*, p. 15.
41. *Ibid.*, p. 16.
42. C.M. Allen-Jones, "Tax Aspects of Leasing", *London Seminar*, *op. cit.*, p. 24.
43. *United Nations Analysis*, *op. cit.*, para. 131.
44. J. Brewer & I. Cochran, "P & O fleet in major refinancing deal", *Lloyd's List*, London, 19 April 1991, p. 1.

C. Leasing in shipping

41. In the early 1970s leasing was introduced into shipping. There are in particular two areas of liner shipping where leasing has proved its advantages. Operating leasing has become a very convenient way for carriers to meet container equipment demands in peak trading conditions. In areas where trade levels are not constant, container leasing enables carriers to cater to the peaks in seasonal trading or unbalanced routes.[45]

42. Financial leasing has become an alternative to be considered in ship financing. Increasing building costs and the technological developments in maritime transport require more flexible forms of financing than those offered under traditional loan agreements. As a consequence, ship leasing as a special form of financial lease, tailored to the peculiarities of shipping, has been developed. Today ship leasing is used as an alternative form of financing for the construction or purchase of a ship where a shipping company is interested in the sole use of the vessel without any particular need to become the legal owner. There are various reasons motivating this choice. First of all, tax relief granted to lessors and/or lessees[46] is frequently different (e.g. owing to differing financial situations of the lessor and lessee, or owing to differing domestic laws applying to each of them) and may cut the overall capital demand. Moreover, leasing arrangements can often provide access to a particular flag for the lessee using bareboat registration if he wishes to operate the ship under such flag for economic reasons or for trading purposes (such as access to cargo).[47] Leasing agreements can also assist joint venture agreements. The joint venture company is entitled to use the vessel, while the actual owner does not lose his ownership rights. Finally, ship leasing may be attractive to a shipping company for balance sheet purposes since sometimes "...local accounting standards allow the company to record a finance lease as a charter because the lessor retains ownership".[48]

43. Ship leasing as described here is a type of financial leasing. The lessor remains owner of the leased vessel, while the lessee has sole use during the lease period. This allows the lessee complete control and possession of the ship in compliance with the terms of the leasing agreement without having legal title to it.

44. The shipping industry has developed various standard forms, providing the legal framework for operating a vessel. In looking at the different forms of chartering a vessel, it is evident that under a voyage charter as well as under a time charter the possession of the vessel remains with the shipowner, although he agrees with the charterer to render the service of the ship for one or more voyages or for a named period. Consequently, neither the time charter party nor the voyage charter party forms can be used as standardized frameworks for ship leasing.

45. Under a bareboat charter, the owner undertakes to leave the unmanned vessel for a certain period in the complete control of the charterer.[49] The transfer of possession is the essential feature of a bareboat charter.[50] In everyday shipping practice, bareboat charter parties are used for different

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[45] For a comprehensive discussion of the advantages and disadvantages see: Temple, Barker and Sloane, Inc., *op. cit.*,

[46] B. Colegrave, "Leasing - a new approach to ship financing", *Norwegian Shipping News*, Oslo, 1981, Vol. 37, No. 16, pp. 13-14.

[47] Some jurisdictions permit ships under a bareboat charter to fly the flag of the State where the charterer has its permanent place of business. Where such bareboat registration is provided for, the ownership and the registered charges on the ship may remain listed in the "original registry". Consequently, the private law functions of the registry are preserved. The public law functions are suspended from the original registry during the charter period. The right to fly the flag of the State where the charterer has his permanent place of business may be documented in the registry of that state. For a detailed discussion of bareboat registration see: B. Kroger, "Practische Erfahrungen mit Bareboat Charter Registern", *Transportrecht*, Hamburg, 1988, No. 5, pp. 173-176. For a concise discussion with examples see V. Polic Curcic, *Registration of Ships under Bareboat Charter with Particular Reference to Dual Registration*, Institute of Maritime Law, Zagreb, 1989. See also: UNCTAD: "Consideration of Maritime Liens and Mortgages and Related Subjects, in Accordance with the Terms of Reference of the Joint Intergovernmental Group", (TD/B/C.4/AC.8/12), p. 15.

[48] I. Lambert, & R. Stewart, "Ship leasing - the Flexible Solution", *Norwegian Shipping News*, Oslo, 1981, Vol. 37, No. 16, p. 11.

[49] Under a bareboat charter it is the normal understanding for the charterer to appoint and employ his own master and crew. However, on occasions by mutual agreement the owner's master, and perhaps even officers and crew, may carry on in the employ of the charterer. See: A. Mocatta, M.J. Mustill, & S.C. Boyd, *"Scrutton on Charterparties and Bills of Lading*, 19th Ed., Sweet & Maxwell, London 1984, p. 47. See also: P. Manca, *International Maritime Law*, 2nd Vol., European Transport Law, Antwerp, 1970, pp. 25-26.

[50] Manca, *op.cit.*, p. 24, and Mocatta, Mustill & Boyd, *op. cit.*, p. 47, with reference to Port Line v. Ben Line Steamers 1958, 2 Q.B. 146.

commercial purposes[51] and generally fall into two categories:

(a) medium term operational; and
(b) long term finance-related.[52]

46. Where a bareboat charter party is associated with a financing structure (e.g. "Barecon A", "Barecon B", or their successor "Barecon 89"), it is very close to a finance lease. In such cases the relationship between ship leasing and bareboat charter parties may be characterized as follows:

> "... the bareboat charter is the contract by which the leasing deal is witnessed between the lessee and the lessor and, as a contract, it is similar to a bareboat charter between any other two parties in that it is a charter for the use of the ship without its crew, insurance or whatever it may be. But a bareboat charter which acts for a lease usually contains various clauses which would not be expected in a straightforward bareboat charter party. These are usually referred to as "hell or high water clauses" - in other words, bareboat hire will continue to be paid and there are really only two events which can cause hire to stop being paid. One is the receipt by the bank (lessor) of the insurance proceeds following a CTL [constructive total loss] the other is the termination of the lease period."[53]

47. In Japan, ship leasing is a small but growing industry. As elsewhere there are financial leases and a version of a leveraged lease, termed in Japan "instalment-sale leasing". Financial leases are similar to those found in other countries, except that as most of the ships concerned are for export, the tax-orientation is either not there or is included to meet the specific requirements and terminology of the foreign lessee's legal and taxation regimes, if benefits can be so obtained. At the completion of the lease there are no requirements to purchase, or restrictions against the lessee purchasing, the vessel at fair market value or at any other negotiated or pre-negotiated level.[54]

48. Owing to the different nature of Japanese lessors and potential lessors, they may have a tax position such that lease financing has negative benefits rather than the positive benefits this attracts in most economies. With the high liquidity in the domestic financial market, the finance houses have surplus funds available for leasing purposes. Thus the lessor may supply little or no funds to the lease and obtain the required funds from another source, very often in-house. A mortgage is still required and in other ways this instalment-sale lease is similar to a leveraged lease.[55] As it is customary, although not essential, to use a Japanese trading house with branches worldwide as an intermediary, especially with export financing, it is also possible to negotiate multi-currency options and cargo contracts between the lessee and the trading house as part of the financial package in the lease contract.[56] As can be readily seen, ship leasing in Japan is frequently not merely ship financing but ship financing as an export ship-building assistance programme.

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51 J. Ramberg, "Allocation of Costs and Risks", Comité Maritime International (CMI) Seminar on Bareboat Charterparties (hereafter called the "Knokke Seminar"), Knokke, Belgium, 1989, p. 3.

52 R. Heward, *Knokke Seminar*, *op. cit.*, p. 1.

53 G.V. Ryan, comments to C.P. Barrington, "Shipowners and Bankers in Leasing", *London Seminar*, *op. cit.*, p. 65.

54 M. Murai, General Manager, Bank of Tokyo, *Ship Finance ... from a commercial banking perspective*, Japan Maritime Research Institute, Tokyo, 1985, pp. 14-17.

55 *Idem.*

56 *Idem.*

CHAPTER II

RIGHTS AND OBLIGATIONS UNDER SHIP-LEASING CONTRACTS

49. Owing to its recent, still continuing development, and to the still limited and fragmentary nature of the specific legislative and legal controls on leasing and, more importantly, ship leasing, there are quite different attitudes and applications of the concept from country to country. This allows combining the guidelines of one country with another, or even various laws within a country, to provide a scope of potential transactions that is extremely wide-ranging. Equally, it brings the contract formulation and operation up against occasionally conflicting and sometimes unexpected limitations. For this reason, certain standardized documentation has been developed for ship leasing but the nature of the business is such that most transactions are tailored to individual requirements so great that care must be taken to comply with all the controls and limitations of the regimes under which the contract will operate.

A. Legislative provisions

50. The rights and obligations under a ship-leasing contract are usually agreed on between lessor and lessee. Specific legislation on ship leasing or financial leasing is rare. Even those jurisdictions where specific legislation on ship-leasing contracts exists accept the principle of freedom of contract. It is only in the absence of contractual stipulations on a special point that legislative provisions are applicable.

51. However, it should be borne in mind that tax aspects are often an important part of the whole leasing negotiation. As a consequence, the parties to a ship-leasing contract may wish to adapt the terms of contract to the existing statutes, administrative provisions, rules and principles constituting the national tax law in order to obtain maximum tax advantages. As already mentioned, an analysis of the different national tax laws would go beyond the scope of this paper. Therefore, the following review of national legislation affecting ship leasing does not focus on this aspect.

52. In France, law no. 66-420 of 18 June 1966[57] and decree no. 66-1078 of 31 December 1966[58] contain special rules on bareboat charter parties. Article 10 of the law gives a general definition of bareboat charter parties while article 11 provides for an obligation of the bareboat charterer to indemnify the shipowner against any third-party claims during the charter period. Moreover, the decree contains particular provisions on:

(a) Shipowner obligations to deliver a seaworthy vessel (article 25) and to remedy defects (article 26);
(b) Charterer obligations to maintain the vessel (article 28) and to redeliver the ship in the same condition as upon delivery (fair wear and tear excepted) (article 29); and
(c) Charterer obligations to pay damages for delay in redelivery (article 30).

53. Many provisions of bareboat charter parties are also applicable to ship-leasing contracts. However, the legislative principles, discussed above, are considered to be non-mandatory law. Parties are free to agree upon contract terms deviating from the legislation.

54. Law no. 66-455 of 2 July 1966[59] dealing with financial leasing (*crédit bail*) governs the legal status of enterprises. This statute was supplemented by ordinance no. 67-837 of 23 September 1967 and by law no. 84-46 of 1 January 1984. These regulations deal in particular with administrative aspects of financial lease agreements and have only a very limited impact on the contractual rights and obligations of lessors and lessees. The "freedom of contract" is not affected by these statutes.

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57 Law no. 66-420, *Journal Officiel*, Paris, 1966, p. 5206.

58 Decree no. 66-1078, *Journal Officiel*, Paris, 1967, p. 483.

59 Law no. 66-455, *Journal Officiel*, Paris, 1966, p. 3652.

55. In the United Kingdom, there is no specific legislation on bareboat charter parties,[60] ship leasing, or financial lease agreements.[61] Nevertheless, since leasing contracts are classified as contracts for hire[62] it has been argued that the "Supply of Goods and Services Act 1982" is applicable to ship-leasing contracts[63] and implies certain conditions as to the state of the vessel at delivery. However, we are reminded: "...the charterer's involvement in the acceptance of specifications and plans and in the construction of the vessel itself is likely to restrict the charterer's rights after delivery within very narrow limits".[64] Since supervision of the whole construction process by the buyer is usually agreed under a shipbuilding contract (and for a ship built to a specific lease this would be included in the lease contract for the lessee's benefit), remedies under the 1982 Act should be restricted.

56. Like French law, the Merchant Shipping Act of the former German Democratic Republic of 5 February 1976[65] contained particular provisions on ship-leasing contracts (articles 87 to 89). In specifying the lessor's obligation to deliver the vessel, article 87 stated that the leased vessel should meet "... the usual requirements..." and that the lessor "... shall supply the ship at the agreed place and time...". The obligation to maintain the vessel during the lease period and the risk of accidental loss or deterioration of the ship rests with the lessee.

57. The provisions on lessor's rights in case of a default in payment and of insolvency on the lessee's part are worth considering in detail. Article 89 reads as follows:

> "(1) In case of default in payment by the lessee in respect of more than two rental instalments which are due successively, the lessor may demand the immediate payment of the outstanding part or the total payment which is due in accordance with the contract.
>
> (2) In case of insolvency of the lessee, the lessor is entitled to demand the return of the ship or the immediate payment of the outstanding part of the total payment which is due in accordance with the contract.
>
> (3) When the ship is returned (by the lessee), the lessor may claim the usual payment for the use of the ship; the share of the purchase price in the leasing rate already paid shall be refunded to the lessee."

58. The remedies granted to a lessor under article 89 of the same Merchant Shipping Act were quite similar to those usually agreed between contractual parties to ship-leasing contracts. However, the above legislative provision limited the lessor's right to claim immediate payment of the total hire (acceleration of rentals) to those cases where the lessee repeatedly failed to pay the rental instalment on time. Unlike article 89 of the Merchant Shipping Act, standard terms of ship-leasing contracts usually consider a simple delay in making a rental installment to be a serious default, which gives lessors a right to claim accelerated payment of the future rentals. Moreover, article 89 required that where the lessee was obliged to return the ship as a consequence of a breach of contract on his side, the purchase price already paid by the lessee must be refunded to him. Such a refund is contradictory to standard and typical non-standard lease agreements in shipping. Almost universally they stipulate, in case of breach of contract on the lessee's side, that the purchase price already paid be retained by the lessor.

59. Under the laws of the Federal Republic of Germany ship leasing is considered to be a contract of hiring a vessel. Specific legislation governing the contractual rights and obligations of the parties under a ship-leasing contract does not exist. The general rules on "hire" are applicable as non-mandatory law.[66]

60. Italy also has specific legislation on financial lease transactions.[67] However, the existing provisions in article 17 of law no. 183[68] are only applicable to financial leases with a lease term of up to

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60 *Knokke Seminar*, *op. cit.*, Questionnaire, p. 2.

61 R.M. Goode, "Equipment Leasing in England", in v. Bieberstein, *Leasingvertrage im handelsverkehr*, (Frankfurt am Main, 1980), p. 68.

62 See Reed v. Dean 1949 1 KB 188.

63 M. Wilford, "Analysis of Contract Clauses", *Knokke Seminar*, *op. cit.*, pp. 1-5.

64 *Ibid*, p. 6.

65 The Merchant Shipping Act of the former German Democratic Republic, Berlin, 5 February 1976, *Official Gazette* I, No. 7.

Note: Through accession of the German Democratic Republic to the Federal Republic of Germany with effect from 3 October 1990, the two German States have united to form one sovereign State. As from the date of unification, the Federal Republic of Germany acts in the United Nations under the designation "Germany".

66 H.G. Abraham, *Das Seerecht in der Bundesrepublik Deutschland*, 4th ed., Vol.1, de Gruyter, Berlin, 1978, p. 444.

67 Momken, *op. cit.*, pp. 75-78.

68 Law no. 183 of May 1976, "Disciplina degli interventi straordinari nel Mezzogiorno per il Quinquennio 1976-1980."

five years. Moreover, the geographical scope of application of the statute is limited to southern Italy. Consequently, it has no impact on international ship-leasing contracts, as discussed here.

61. Legislation, as far as it exists, does not usually affect the parties' freedom of contract. The rights and obligations of lessor and lessee are agreed upon between the parties, as a result of their negotiations. These negotiations are simplified by standard form contracts. Typical clauses from standard lease contracts used in shipping are examined in the following section. The Barecon 89 as a typical "finance-related bareboat standard charter party" and the "Standardlease Agreement" hereafter referred to as Standardlease[68] will serve as examples.

B. Principal contractual stipulations

(1) Lessor's obligation to deliver the vessel

62. The lessor's undertaking to deliver the leased vessel at the agreed time and place is a principal obligation under ship-leasing contracts and does not usually cause any legal problems. Nevertheless, it must be borne in mind that ship-leasing transactions are usually constructed as tripartite deals between the lessor, the lessee and the builder or seller of the vessel, who has been selected by the lessee. Consequently, an entire ship-leasing deal would actually consist of two different contracts - the building or purchase agreement between lessor and shipyard or seller, and the contract between lessor and lessee ("charter party"). From a legal point of view each contract is independent of the other. However, the mere fact that they serve the same commercial purpose is reflected in the contractual stipulations agreed between the parties as to the specification of the vessel and the remedies granted to the lessee under the charter party. Part III of Barecon 89 states:

> "(a) The Vessel shall be constructed in accordance with the Building Contract ... as annexed to this Charter, made between the Builders and the Owners and in accordance with the specifications and plans annexed thereto, such Building Contract, specifications, and plans having been countersigned as approved by the Charterers." ... and
>
> "(d) The Vessel shall be built in accordance with the Building Contract and shall be of the description set out therein provided nevertheless that Charterers shall be bound to accept the Vessel from the Owners on the date of delivery by the Builders as having been completed and constructed in accordance with the Building Contract and the Charterers undertake that after having so accepted the vessel they will not thereafter raise any claims against the Owners in respect of Vessel's performance or specification or defects, if any, except that in respect of any repair or replacement of any defects which appear within the first 12 months from delivery, the Owners shall use their best endeavours to recover any expenditure incurred in remedying such defects from the Builders, but shall only be liable to the Charterers to the extent Owners have a valid claim under the guarantee clause of the Building Contract."

63. A similar stipulation can be found under article 6 of Standardlease where the parties agree that:

> "(1) The Lessee, having itself negotiated with the Seller and having selected the Vessel for its own operations, hereby acknowledges that the Lessor shall not be responsible ... for any defects or for function or fitness for any particular purpose of the Vessel. (2) In the event the Lessee suffers damage in consequence of any delay in delivery of or defect in the function of or unfitness of the Vessel ... the Lessor agrees to assign to the Lessee, at the Lessee's expense, the right to seek compensation for such damages from the Seller, but nothing herein contained shall be construed as a representation by the Lessor that any legal possibility exists of recovering such compensation and the Lessor shall make no such representation."

64. Two characteristics can be derived from the wording of the above clauses, dealing with the obligation of a lessor to deliver the ship under a ship-leasing contract. First, the vessel is ordered and purchased by the lessor, but the lessee selects the vessel and, if it is to be a newbuilding, approves the building plans and supervises the construction process. Moreover, the lessee also appoints the yard where the vessel will be built. In other words, the lessor only finances the construction of the ship; his rights as purchaser to interfere with the construction process are exercised by the lessee. Second, as a consequence, any responsibility of the lessor for delay in delivery or for defects in the vessel is completely excluded under the charter party. The lessor only undertakes either to:

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[68] *United Nations Analysis, op. cit.*, Annex III.

(a) "...use their best endeavour to enforce possible claims against the builder and to pass the benefits arising out of these claims to the lessee" (Barecon 89); or to

(b) "...assign any remedies granted under the Building Contract in case of unsatisfactory performance to the lessee" (Standardlease).

65. Thus the lessor's obligation to deliver the leased vessel is quite different from an owner's usual obligation under voyage or time charter parties. The seaworthiness of the vessel - a central aspect in voyage and time charter parties - is usually of no significance in ship-leasing contracts.[70] As strictly a financier, the lessor disclaims any warranty regarding the condition of the ship.

(2) Payment of rental

66. The lessee's obligation to pay the rental is usually governed by comprehensive contractual stipulations. The general obligation to pay rental is set out in clause 10 of Barecon 89 and article 3 of Standardlease. Clause 10 Barecon 89 reads as follows:

"The Charterer shall pay to the Owners for the hire of the Vessel a lump sum per calender month as indicated in Box 21 commencing on and from the date and hour of her delivery to the Charterers and at and after the agreed lump sum for any part of the month. Hire to continue until the date and hour when the Vessel is redelivered by the Charterers to the Owners."

67. Article 3 of Standardlease follows a similar approach in stating:

"The prepaid rent and the rent for the Vessel, and the currency and method and place of payment thereof, shall be as described in items (6) and (7) of the Schedule."[71]

68. In this context it seems worthwhile to take a closer look at the calculation of the lease rental or hire. Under both standard form contracts a lump sum rental is agreed upon. Since ship leasing is essentially a method of financing, the overall lease hire covers:

(a) The purchase price of the vessel;
(b) Lessor's cost of financing the purchase (interest);
(c) Administrative and other expenses of the lessor; and
(d) Lessor's profit.

69. In other words, the lease rental is usually calculated in such a way that the costs of the whole leasing transaction have been repaid by the lessee by the end of the lease period. This is the typical feature of any full-payout lease transaction such as a ship-leasing contract. However, tax relief[72] granted to the lessor may reduce the overall cost. It is commonplace in ship leasing for those benefits to be partly passed on to the lessee.[73]

70. As mentioned above, the lease rental is calculated on a lump sum basis irrespective of the employment of the vessel. Consequently, stipulations under ship-leasing contracts usually provide that hire continues to be payable by the lessee even in cases where a defect in the vessel prevents its operation. In other words, ship-leasing contracts do not usually contain so-called "off-hire clauses". Clause 13 (f) Barecon 89 expressly states, that:

"...All time used for repairs ... shall count as time on hire and shall form part of the Charter period."

Article 13 (6) of Standardlease deals similarly with the "off-hire" problem, reading as follows:

"(6) For avoidance of doubt it is expressly agreed that the rent shall continue to be payable by the Lessee:

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[70] The right of the parties to enter into a bareboat charter wherein the owners disclaim any responsibility for seaworthiness was approved by a court in the United States in Zidell Inc. v. Barge ZPC 404, 661F. Supp. 1696, 1987 AMC 2494, (W.D. Wash. 1987). See: J.D. Kimball, "Allocation of Risks and Costs," *Knokke Seminar*, *op. cit.*, p. 2.

[71] Items (6) and (7) provide for the exact date and place of payment. It is furthermore mentioned that the prepaid rental is calculated on the basis of the purchase price of the ship.

[72] For a review of the different forms of tax advantages available under a ship-leasing arrangement see: Allen Jones, *op. cit.*, p. 41.

[73] Nevitt, *op. cit.*, p. 41.

(1) notwithstanding that the vessel (i) be subject of capture and/or seizure ... or (ii) be lost or missing, or (iii) be the subject of ... a Notice of Abandonment or (iv) be requisitioned for hire, unless the Lessor shall in such case give the Lessee notice of discontinuance of this Lease. PROVIDED HOWEVER that when the Vessel's underwriters shall compensate the Lessor for such capture, ... or loss the rent shall cease to be payable by the lessee.
(2) notwithstanding that the Vessel may be under arrest or detention by any court or the judicial authority;
(3) notwithstanding that the Vessel may be damaged or unnavigable or any of her certificates have expired or are otherwise invalid or not in order."

Since the off-hire concept is not incorporated into ship-leasing contracts, the lessee bears the entire risk in the operation of the vessel.[74]

71. The comprehensive stipulations on lease rental under ship-leasing contracts usually include detailed provisions on the remedies available to a lessor when the lessee delays making rental payments. Barecon 89 contains a typical "withdrawal clause" but it cannot be considered to be representative in this context. Clause 10 (e) reads in part as follows:

"... In default of payment beyond a period of seven running days the Owners to have the right to withdraw the Vessel from the service of the Charterers without noting any protest and without interference by any court or any other formality whatsoever ... without prejudice to any other claim the Owners may otherwise have against the Charterers under the Charter ..."

72. Article 14 of the Standardlease may serve as an example of a typical clause under ship-leasing agreements. It states:[75]

"(1) If the Lessee fails to pay the rent ... after the same becomes due and payable, ... the Lessor shall have the right to exercise any one or more of the following remedies without having to give any prior notice or demand to the Lessee:

(a) to declare a part of or the entire amount of the total rent payable under the Agreement and all other costs and expenses immediately due and payable;
(b) to withdraw the Vessel from the Lessee or demand its return;
(c) to terminate the leasing created by this Agreement and to look to the Lessee for compensation for all direct and consequential damages including loss of profits.

(2) Even if the remedies provided for in (a) and (b) of the preceding paragraph have been taken by the Lessor, the Lessee shall not be relieved from any other liability under this Agreement including particularly liability for damages."

73. It can be inferred from the usual contractual stipulations under ship-leasing contracts that:

(a) Failure to pay the rental in time is considered to be an event of default. A grace period, as granted under Barecon 89, is often agreed upon under ship-leasing contracts.[76]

(b) In case of the lessee's default, typical remedies may be any of the following:

(i) Termination of the ship-leasing contract;
(ii) Right to claim immediate payment of the outstanding part of the total lease hire that falls due immediately (acceleration);
(iii) Repossession of the vessel, with the costs of repossessing borne by the lessee; and
(iv) Claim for damages granted to the lessor.

74. All remedies are cumulative and it is up to the lessor which remedy he wishes to elect and to enforce against the lessee. Usually he will combine the different options in reacting to the lessee's default. It appears from this short analysis that any delay in rental payments leads to very harsh treatment of the lessee. He usually not only loses his right to possession, but also suffers a wide range of additional penalties. However, it is only fair to remember that national courts may refuse to enforce some of these stipulations under the "unfair terms of contract legislation".[77]

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[74] For the off-hire problem in bareboat charter parties see: Ramberg, *op. cit.*, pp. 7-8.

[75] *United Nations Analysis*, *op. cit.*, para. 170-183.

[76] *Ibid.*, para. 176.

[77] This may especially happen in German law where the "Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen" of 9 December 1976, *Official Gazette*, Berlin, Part I, p. 3317, could also be applied to these stipulations of ship-leasing contracts. See: B.S. Schmitz & L. Wolpert, *Münchener Vertragshandbuch*, 2nd. Vol., Beck,

(3) Allocation of risks

75. The transfer of exclusive possession and control of the vessel to the lessee is essential to any ship-leasing contract. As a consequence, the typical risks of ownership are also passed to the lessee. Even though the lessor remains the "formal" owner, it will appear from an analysis of the typical clauses under Barecon 89 and Standardlease that risks such as the following examples, usually borne by a shipowner, rest on the lessee:

(a) Risk of employment - As already discussed above, the "off-hire" concept has no place in ship-leasing contracts. The lease rental continues to be payable by the lessee even if the vessel is out of operation. The employment of the vessel rests entirely with the lessee. Unless the vessel is lost,[78] operation of the leased ship is the lessee's responsibility. He is obliged to pay the lease rental irrespective of whether or not the ship is able to perform; or

(b) Risk of fortuitous loss of and damage to the vessel - Ship-leasing contracts usually contain clear stipulations on the consequences of loss of the ship.

76. Barecon 89, Clause 10 (d) states:

"Should the Vessel be lost or missing, Hire to cease from the date and time when she was lost or last heard of. Any Hire paid in advance to be adjusted accordingly."

77. In placing the risk of fortuitous loss of or damage to the ship, Barecon takes as a general principle that this risk is usually covered by insurance. The costs of insurance and the obligation to take out comprehensive hull and machinery coverage rest with the lessee (charterer). However, the lessee has to obtain the approval of the lessor regarding the terms of the insurance contract and the appointment of the insurer. The lessee bears only personal risk in the case of loss or damage to the vessel in relation to claims which would normally have been covered by the insurance policy but which the insurer may decline to pay because of some serious fault by the lessee under the contract of insurance, such as breach of an expert's warranty, or non-disclosure of a material fact at the time of the insurance proposal where the loss or damage would in any event have fallen outside the scope of the policy agreed on between lessor and lessee. Because the peril is not included in the cover provided, the risk falls on the lessor and not the lessee. Finally, a total or constructive total loss of the vessel releases the lessee from his obligation to pay lease rental. Upon settlement of the claim, the lessee has to pay for the insurance covering the risk, while the lessor accepts that in case of a constructive total loss the ship-leasing contract is considered to be terminated. In other words, the lessor bears the risk of losing the lease rental but obtains the owner's reimbursement from the lessee's insurance which he has approved.

78. Standardlease follows a different approach. Article 11 reads as follows:

"(1) The Lessee hereby assumes and shall bear the entire risk of loss and damage to the vessel which may be caused until redelivery of the Vessel (ordinary wear and tear only excepted).
(2) In the event of loss or damage to the vessel, the Lessee, at his cost and expense and at the option of the Lessor, shall:

(a) place the same in good repair, condition and... working order, or...
(b) replace the same with like Vessel in good... repair, condition and working order.

(3) In the event of the Vessel being totally lost (including constructive total loss or infringement of ownership), the Lessee shall pay to the Lessor the stipulated loss value described in item (9) of the Schedule.

79. Unlike Barecon, the stipulations under Standardlease do not refer to insurance to cover the risk of fortuitous loss of or damage to the vessel. The lessee bears the complete risk. Of course it is up to him to take out adequate insurance to cover this risk but, to the extent that no insurance coverage is ever fully comprehensive, an element of non-insurable risk will always remain with the lessee. Furthermore, the lease rental continues to be payable by the lessee even if the vessel has become a total loss. However, where the lessor is compensated by the hull and machinery underwriters for the total

Munich, 1982, pp. 65-66 and 72-74. The British "Unfair Contract Terms Act 1977", (which is only applicable to commercial charter parties with respect to claims for death and personal injuries) would not be applicable to this. Wilford, *op. cit.*, p. 5.

[78] The consequences of a total or constructive loss of the leased vessel are considered below.

loss, the lessee is released from the contractual obligation to pay rental installments. Article 13 (6) expressly provides, that:

> "... the rent shall continue to be payable by the Lessee: a) notwithstanding that the vessel ... (ii) be lost or missing ... PROVIDED HOWEVER that when the vessel's underwriters shall compensate the lessor for such ... loss the rent ceases to be payable by the lessee ..."

80. Although the stipulations under Standardlease may result in a harsh treatment of the lessee in case of loss of or damage to the vessel, they are quite usual under ship-leasing contracts.[79] Again, taking into account that the lessor is only the financier of the lessee's use of the vessel, it should be no surprise that he does not accept responsibility for its operation.

(4) Maintenance of the vessel

81. As indicated above, under a ship-leasing contract, the vessel is in the complete possession of the lessee with the lessor to a large extent having no control over it. It seems to be a logical consequence of the commercial purpose of ship leasing that, contrary to the general rule in "contracts for hire",[80] the lessee as the hirer has the obligation to maintain the vessel in good order and condition during the lease period.[81]

82. Barecon and Standardlease follow an almost identical approach to this question. Clause 9 (a) of Barecon 89 states: "... the Charterers shall maintain the Vessel ... in a good state of repair ...," while article 8 of Standardlease requires that: "... the Lessee shall, during the lease period, take all reasonable steps at his own expense ... (1) to maintain the vessel ... in good state of repair and in efficient operating condition ..."

(5) Redelivery

83. At the end of the lease period, the lessee is obliged to redeliver the vessel to the lessor:

> "... in the same or as good structure, state, condition, and class as that in which she was delivered, fair wear and tear not affecting class excepted" (Barecon 89 clause 14).

Standardlease wording is similar (article 18 (3)) but omits any reference to class.

84. The lessee's obligation to redeliver the ship does not usually pose serious legal problems. However, after expiration of the lease period, another aspect attracts the attention of the parties. The purchase price of the vessel, originally paid by the lessor, has been repaid by the lessee as part of the total lease rental by the end of the lease. Consequently, the lessee wishes to benefit from the retained value of the vessel after the expiration of the term of the lease. But leasing companies are primarily financial institutions and are not normally interested in operating vessels themselves.[82] As a consequence, one of the following options is usually granted to the lessee under a ship-leasing contract:

(a) The lessee is entitled to renew the lease and to pay a considerably lower rate under the renewed lease agreement;
(b) The lessee has an option to purchase the vessel or a right of first refusal. Such a purchase option may be supplemented by an additional agreement concerning the purchase price or the principles of its calculation; or
(c) The parties agree for the lessee or the lessor to sell the vessel and share the proceeds in a pre-arranged manner.

85. A typical purchase option can be found in article 17 of Standardlease, which reads:

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79 *United Nations Analysis, op. cit.*, pp. 31 and 51.

80 See B. Reynardson, "Rights and Obligations", *Knokke Seminar, op. cit.* pp. 3-4.

81 See B. Kroger, "Rights and Obligations", *Knokke Seminar, op. cit.*, pp. 5-6.

82 C.F. Barrington, "Shipowners & Bankers in Leasing", *London Seminar, op. cit.*, p. 63.

"(2) The Lessee shall have the option of purchasing the vessel from the Lessor for... at the expiration of the Lease period ..."[83]

A typical hire-purchase agreement is attached to Barecon 89 in the optional Part IV.

86. These options may, however, be limited or completely prohibited by national legislation. In some jurisdictions, tax laws provide very strict limits within which a contract is considered to be a leasing agreement under which parties enjoy special tax benefits.[84] Sometimes leasing contracts including a hire-purchase agreement (Barecon 89) are governed by specific legislation and do not fall into the category of lease agreements.[85] These legal restraints should not be over-emphasized since parties may adapt the contractual stipulations of the lease to the applicable legislation. It is advisable to investigate thoroughly the applicable legal rules before negotiating the terms of contract in the most mutually advantageous manner.

C. *Summary*

87. The above analysis shows that the particular commercial purpose of ship-leasing contracts results in a typical structure of very special rights and obligations characterizing ship-leasing contracts. The clauses agreed between lessor and lessee of a ship are quite different from both the well-known clauses in the traditional charter parties in shipping (voyage and time charter parties) and the stipulations characterizing usual contracts for hiring a chattel. The lessor is supposed to act only as a financier and to finance the use of the ship for the lessee. As "formal" owner, the leasing company "... own(s) the ship only for the purpose of obtaining security for the loan extended to the 'real' shipowner".[86] The lessee has entire possession and control of the leased ship. He is responsible for its operation and the typical risks of ownership are placed with him. The character of ship leasing as an instrument of ship financing also determines the treatment of the lessee in case of any delay in paying the lease rental. The typical contractual stipulations in a ship-leasing contract thus reflect the particular commercial motives of the parties involved in each lease transaction.

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83 *United Nations Analysis*, *op. cit.*, para. 206-212.

84 Under German law a contract is considered to be a "leasing agreement" enjoying special tax treatment if the lease period specifically covers between 40 and 90 percent of the average life of he ship. See also: Bordwin, *op. cit.*, p. 3.

85 In the United Kingdom those contracts are governed by the "Hire-Purchase Act". As a consequence the lessee is considered to be the owner of the vessel and the capital allowance is shifted to the lessee.

86 Ramberg, *op. cit.*, p. 3.

CHAPTER III

RISKS UNDER SHIP-LEASING CONTRACTS

88. It has been shown that the typical risks of ownership are shifted to the lessee under a properly drafted ship-leasing contract. However, while the lessee undertakes many of the owner's risks, there are still residual risks of which a lessor may not be relieved. In this, the lessor perhaps runs more risks than the lessee. Normally, a corporation requiring financing to obtain capital equipment, no matter how secure the corporation appears to be, could be expected to be a greater financial risk than a corporation with sufficient funds to provide the financing itself. Thus, this chapter concentrates on the lessors' risks. Over the past few years, the financial community has seen both large and smaller banks close their doors and not a few other financial houses follow suit. Only a few years ago many of these institutions were well-known and respected names in the ship-finance field. These risks to lessees are, therefore, also considered.

A. Third party claims

(1) Contractual obligations of the lessee

89. Having complete control and entire possession of the ship, the lessee is solely responsible for the operation of the vessel. Consequently, he negotiates and concludes the contracts for supplies ordered by him as well as the contracts for carriage of goods. As party to these contracts, the lessee bears the risk of contractual liability. The lessor is in no way involved in the lessee's transactions and the contractual obligations of the latter do not have any direct impact on the lessor's position as the "formal" owner of the vessel.

90. However, under most national jurisdictions contractual claims against the operator of a vessel also give rise to a maritime lien. As lienholder, a claimant is entitled to enforce his maritime lien by arresting the vessel and applying for a forced sale of the ship, irrespective of the fact that the lessor as her owner does not personally owe anything to the claimant. The list of claims creating a maritime lien differs from country to country. The legal system of the United States,[87] with a list of maritime liens which "... is, at least theoretically, open-ended... ,"[88] is an extreme example of a jurisdiction which grants maritime liens for almost all maritime claims.

91. Without going into detail, it can be stated that the following contractual claims against an operator of a vessel give rise to a maritime lien in almost all jurisdictions:

(a) Wages and other sums due to the master, officers and other members of the vessel's complement in respect of their employment on the vessel, including contributions payable on their behalf;
(b) Claims arising out of salvage operations; and
(c) Port, canal and other waterway dues and pilotage dues.[89]

92. Some jurisdictions also grant maritime liens for claims arising out of contracts for supplies for the vessel as well as for cargo claims.[90] Since the vessel is affected by various jurisdictions during the lease period, it is impossible for a lessor to calculate the extent of the risk that contractual claims against the

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87 For a comprehensive discussion of the character and history of maritime liens in the United States see: G.L. Varian, "Rank and Priority of Maritime Lien", Tul. L.R., New Orleans, 1973, no. 47, p. 751.

88 Gilmore & Black, "The Law of Admiralty", 2nd. ed., Foundation Press Inc., New York, 1975, p. 633.

89 For a comprehensive review, see: CMI, "Maritime Liens and Mortgages", Annex II, (Doc. MLM-1926/1967 - 27/iv 1983), Brussels, 1983.

90 Abraham, *op. cit.*, pp. 1512-1515.

lessee arising during the lease period may result in maritime liens enforceable against the vessel.

93. However, the existence of maritime liens is not the only risk facing the lessee. Under Anglo-Saxon law, a claimant may be entitled to enforce a contractual claim against the lessee, as the operator, without having any lien by a so-called action *in rem* against the vessel, even though the owner of the vessel is not the personal debtor. Under the United Kingdom Supreme Court Act 1981,[91] a claim that does not give rise to a maritime lien can be enforced by an action *in rem* provided that, "the person who would be liable on the claim in an action *in personam* was when the cause of action arose the owner or charterer or in possession or control of the ship and when the action was brought was either the beneficial owner of that ship ... or the charterer of it under a charter by demise."[92] Consequently, English law[93] entitles claimants against the lessee to enforce their claims arising during the lease period by proceeding against the vessel in an action *in rem*.

94. To summarize, any financier entering into a ship-leasing contract has to keep these risks in mind; for various reasons, claims arising out of the lessee's contractual activities may affect the lessor's ownership interest in the vessel, although he has personally nothing to do with the employment and operation of the vessel during the lease period.

(2) Contractual obligations of the lessor

95. As already mentioned, the lessee has complete control over the vessel during the lease period. He negotiates and concludes the contracts for necessary supplies as well as the contracts for carriage of goods. Since the master is employed by the lessee, he signs the bills of lading on behalf of the lessee. He never creates an obligation of the lessor to carry goods or to safeguard the cargo during the voyage. This must always be borne in mind if the question of legal consequences of lessor's contractual obligation for the leaseagreement are discussed.

96. Of course, a lessor also enters into contracts with other parties and may have investments in other areas. As part of everyday business, he negotiates contracts with other parties and is obliged to perform his contractual obligations. However, these contractual obligations usually have nothing to do with the operation of the leased vessel. Moreover, such contracts do not create so called 'maritime claims' giving rise to a maritime lien on the vessel. Even under Anglo-Saxon law, the claims of the contractual parties of the lessor cannot be enforced by an action *in rem* against the ship, since only maritime claims are entitled to take such action.

97. Nevertheless, a vessel under a lease agreement belongs to the overall assets of the lessor, even during the lease period. As a consequence, a claimant who is entitled to enforce a claim against the lessor by arresting the lessor's property may also be entitled to arrest a ship that is under a lease agreement. The right to ask for arrest of debtor's property in order to enforce a claim can only be granted by a court authority. The legal requirements for such an arrest are governed by national laws. However, as far as the arrest of ships is concerned, internationally unified principles were agreed upon by the international shipping community under the "International Convention for the Unification of Certain Rules Relating to the Arrest of Sea-Going Vessel, 1952". As one principle under the Convention, a ship flying the flag of a member State may be arrested only in respect of a maritime claim. Maritime claims are defined in article 1 of the Convention. Since the ordinary contractual obligations of a lessor cannot be classified as maritime claims, they cannot be enforced by an arrest. Thus under the Convention, it is quite unlikely that the lessor's claimants would be entitled to arrest the lessee's vessel. However, not all shipping nations have ratified the Convention. Therefore the risk to a lessee that the leased vessel may be arrested often depends on the national law of the port State.

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91 Supreme Court Act 1981 (c. 54).

92 D.C. Jackson, "Enforcement of Maritime Claims", Lloyd's of London Press Ltd., London, 1985, p. 74.

93 The action *in rem* is well known and accepted in all jurisdictions with Anglo-Saxon roots.

(3) Tort claims

98. During the lease period, third-party claims may also be based on liability in tort, where damage has been caused to a third party as a result of the operation of the leased vessel. It has already been stressed that the lessee is in full possession and control of the vessel during the lease period. Therefore, he is considered to be the "temporary owner" (owner *pro tempora*) of the ship and entirely responsible for its operation.

99. However, like contractual claims, a claim in tort can also give rise to a maritime lien or may entitle the claimant to proceed in an action *in rem*. The effects of these legal instruments on the lessor's position have already been discussed above.

100. The question to be answered is whether, and to what extent, the lessor as the "formal" owner of the vessel may also be held personally liable for damage done by the vessel during the lease period. National jurisdictions take a different approach to this problem. Under German law[94] it is expressly stated that the person who operates the vessel is personal liability for any damage unlawfully caused to a third party as result of the operation of the vessel.[95] A similar approach is taken under English law, where the employer of the master and crew whose negligent act caused the damage is personally liable[96] (negligence rule). Since the lessee appoints and pays the master and the crew, he is liable for damage done by negligent acts of those persons to third parties. In general, United States law also channels general liability for damage caused by the ship to the lessee.[97]

101. However, the situation is different under French law where the formal owner of a ship personally is responsible for any damage done to third parties. It is suggested that this also applies to "bareboat charter parties".[98]

102. While a lessor, as formal owner of the vessel, may be generally exonerated from tort liability under some national jurisdictions, he always faces the risk of being held liable for oil pollution damage caused by the leased vessel. Article III (4) of the International Convention on Civil Liability for Oil Pollution Damage 1969 (CLC '69)[99] and article 4 (2) of the 1984 Protocol amending the CLC '69[100] have expressly channelled the liability for oil pollution damage to the owner of the vessel.

103. The incident involving the tanker "The Tanio" which occurred off the coast of Britanny (France) in 1980 may serve as an illustration. The tanker, owned by La Societé Locafrance International Leasing (Locafrance), was leased to La Societe Guardiola Shipping Corporation and sub-chartered to La Compagnie Malgache de Transports Petroliers. Even though Locafrance as lessor was only the "formal owner" and was not responsible for the operation of the ship, the International Oil Pollution Compensation Fund (IOPC Fund) sued Locafrance (among others) in order to recover the amounts paid by the Fund to the claimants. In an out-of-court settlement the parties finally agreed, that:

> "... Locafrance and the UK Club pay, on behalf of all defendants, a total amount of US$ 50 million to the IOPC-Fund and the French State, less the shipowners' limitation amount under the Civil Liability Convention, FRF 11,833,717.79 (USD 1,931,089.71)."[101]

104. Even though "The Tanio" was one of the major oil spills, the example shows that the risk of the lessor being held liable for oil pollution damage can result in a huge amount of money being payable by an owner who is only interested in ship financing and has actually nothing whatsoever to do with the operation of ships.

105. The United States Oil Pollution Act (OPA) of August 1990 specifically places the final liability

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94 For a detailed discussion of shipowner's liability under German law see: R. Herber, *Das neue Haftungsrecht der Schiffahrt*, Kehl & Rhein, Engel, 1989.

95 See: section 510 and 485 of the Handelsgesetzbuch (HGB) of 10.05.1897, version of 10.05.1987, *Official Gazette*, III 41000-1.

96 See C.K. McGuffie, "Four British Shipping Laws", "Collisions at Sea", 11th. ed., Sievens & Sons, London, 1961, p. 64.

97 Gilmore & Black, *op. cit.*, pp. 241-242 with reference to "*The Barnstable*", 181 U.S. 464, 21 S. Ct. 684, 1901.

98 Ramberg, *op. cit.*, p. 6, with reference to: G. Ripert, "Droit Maritime I", Paris: Dalloz, 1967, p. 674, and R. Rodiere, "Traite générale de droite maritime I", Dalloz, Paris, 1967, p. 309.

99 CMI: "International Conventions on Maritime Law", Brussels, 1987, p. 129.

100 *Ibid.*, p. 214.

101 IOPC Fund, "Information on, and approval of, Settlement of Claims, "*The Tanio*", FUND/EXC. 20/2, p. 10.

on the owner (lessor) of vessels. The United States Coast Guard lawyers who provided the bulk of the input in drafting this statute have expressed doubt that anyone would attempt to recover against the financier for pollution damage caused by a mortgaged vessel.[102] Notwithstanding this opinion, who could say that the United States Government will not some day attempt to collect oil spill clean-up costs from a lessor. With environmental damage costs becoming so great, trading to and from the United States being a major part of world shipping, and lessors not being in a position to control where lessees operate their ships, this has suddenly become a major worry of all ship financiers. However for many years there have been various state laws along similar lines of which these same owners have been blithely unaware or have ignored without this causing any worry, legal problems or historically significant loss. Similarly, the Comprehensive Environmental Response Compensation and Liability Act (CERCLA) of 1981, covering land-based pollution damage and spills of substances other than oil (e.g. ammonia) at sea has resulted in little worry, few costs, and no general protective action by lessors. In one well-known case under this law, it was found that a lender was not liable but that he could be liable only for clean-up costs and that only under certain circumstances.[103]

106. In summary, it appears from the foregoing that although the lessee is responsible for the operation of the vessel and is considered to be the temporary owner during the lease period, the lessor is not necessarily relieved of all liability arising out of the employment of the vessel. His liability may either be engaged under national law (e.g. France, United States), specific legislation such as the CLC 1969, or his vessel might be the subject to maritime liens or *in rem* proceedings.

107. Neither contractual stipulations[104] obliging the lessee to indemnify the lessor for any damage arising out of the operation of the vessel[105] nor so-called "anti-lien clauses"[106] are appropriate means of providing effective protection for the lessor. Any claim for indemnity will only safeguard the lessor's interests as long as the lessee is actually able to meet his financial responsibilities arising out of this obligation. There are no doubts that a lessee is bound by an "anti-lien clause". However, such a stipulation does not usually affect the rights of a claimant who is not aware of the clause. Maritime liens exist by law irrespective of contractual stipulations.[107]

108. A comprehensive protection and indemnity (P & I) coverage seems the most efficient way to preserve the lessor's interests, because it makes sure that third party (tort) claims arising during the operation of the vessel are finally settled by the P & I Club. The risk of direct actions taken by the claimant against the lessor or the ship can be considerably reduced by such insurance coverage. (However, it should be borne in mind that claims resulting from lessee's contractual liability are usually not covered by P & I insurance). Consequently, the lessee is usually obliged to take out a comprehensive insurance coverage during the lease period. Article 12 of Standardlease reads: "During the lease period the vessel shall be kept insured by the Lessee at his expense with first class insurance satisfactory to the Lessor ....against marine, war and Protection and Indemnity risks ... " Barecon 89 follows the same approach by providing in clause 12: "During the Charter period the vessel shall be kept insured by the charterers at their expense against Marine, War and Protection and Indemnity risks in such form as the Owners shall in writing approve...."

109. The use of a so-called "leverage lease construction", as another way to improve the lessor's position, will be discussed below.

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102 G. Wolfe, a partner with New York law firm Hill, Betts & Nash, in *Lloyd's List*, London, 8 March 1991, p. 4.

103 *Ibid.*, "*The Fleet Factors*" case.

104 Under French law such an obligation is placed on the charterer under a bareboat charter by statute (article 11 of law no. 66-420).

105 See: clause 7 (5) of Standardlease, and clause 15 of Barecon 89.

106 As in the superseded "Barecon B" Charter party, cl. 14.

107 For a discussion of this problem see: Ch.S. Haight, "Current Developments in the American Law of Maritime Liens and Mortgages", Mar. law, Vol. 9, No. 1, New Orleans, 1984, pp. 9-11.

B. Bankruptcy proceedings

(1) In the instance of lessee's bankruptcy

110. Potential liability of the lessor for ordinary contract or tort claims arising out of the operation of the vessel is only one aspect of the risks facing a lessor where the lessee fails to meet his financial obligations. There cannot be any doubt that the interests of a lessor are considerably affected if the lessee's insolvency results in the commencement of bankruptcy proceedings against the lessee. The legal consequences of this are determined by the applicable national bankruptcy law. A comprehensive discussion of the various principles under the different national legal systems would go beyond the scope of this study.[108] Nonetheless, attention should be drawn specifically to the following two aspects:

(a) The extent to which an existing ship-leasing contract is affected by the commencement of bankruptcy proceedings against the lessee; and
(b) Whether or not the ship (or the lessee's interest in the ship) becomes part of the bankrupt estate.

111. These two factors always depend upon national law as applied by the bankruptcy court. A comparison of German and United States law may illustrate the different approaches taken under different national jurisdictions. Under the law of the United States,[109] the lessee's interest under the ship-leasing contract is considered to be a "property interest" and becomes part of the bankrupt estate. As a consequence, a lessor is not entitled to terminate the ship-leasing contract or repossess the vessel after the bankruptcy proceedings have been commenced (automatic stay). It is up to the trustee to either assume or reject the unexpired lease.[110] Of course, the trustee must pay the hire if he decides to accept the ship-lease contract. Alternatively, the lessor may take part in the bankruptcy proceedings with his claim for damages in case of a rejection of the lease.

112. A different approach is taken under German law. It was held by the Supreme Court[111] that, in accordance with section 19 of the *Konkursordnung* of 10.02.1877 (German bankruptcy law), both the trustee and the lessor are entitled to terminate the leasing contract after bankruptcy proceedings have been commenced against the lessee.[112]

113. However, even if the vessel is considered to be part of the bankrupt estate, the lessor's interests as owner of the vessel are protected under United States law. He may request the bankruptcy court to lift the automatic stay and permit him to repossess the vessel if the "... bankrupt debtor is unable to provide adequate protection for the lessor's interests".[113] As an example, the courts have granted such relief where the debtor has failed to take out proper insurance cover.[114]

114. Under German law (section 43 of the *Konkursordnung*), a so-called *Aussonderungsrecht* (right for separation) is granted. This entitles the lessor to claim repossession of the leased vessel after the ship-leasing contract has been terminated.[115]

115. Since a lessor may face various problems after bankruptcy proceedings have been commenced against the lessee, Standardlease particularly provides the lessor with the remedies agreed under the contract by making the lessee's acts of bankruptcy an event of default. Article 15 of Standardlease reads as follows:

> "Should any one of the following events take place with respect to the Lessee, the Lessor ... may exercise the remedies as provided for in paragraph (1) of article 14.

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[108] For a comparative discussion see: H. Fincke, *Die Anspruchssicherung im Auslandskonkurs*, Berlin, 1987, pp. 67-69.

[109] R.B. Barnett, "Protection of Lessors", Colloquium on protection against insolvency in maritime law, (hereafter called the "Tulane Colloquium"), Tulane University, New Orleans, 1987, pp. 80-86.

[110] *Ibid.*, p. 82.

[111] Decision of the Supreme Court of 05.04.1978, BGHZ 71, p. 189.

[112] U. Jorgens, *Die Entwicklung des Finanzierungsleasings*, Dissertation, Cologne, pp. 95-96.

[113] Barnett, *op. cit.*, p. 82.

[114] Fincke, *op. cit.*, with reference to "In re Stagedoor, Inc.", 32 B. R. 13, Bankr. W. D. Pa 1983.

[115] Cf. W. Canaris, *Bankvertragsrecht*, (2nd. ed.), de Gruyter, Berlin, 1981, p. 914.

(1) ... suspension or discontinuance of business of the Lessee or bankruptcy or dissolution of the Lessee..."[116]

116. Such a stipulation gives the lessor the right to terminate the ship-leasing contract and to repossess the vessel upon commencement of bankruptcy proceedings against the lessee. It has been suggested[117] that such a provision would not be recognized by courts in the United States. However, the stipulation may also entitle the lessor to terminate the lease agreement before bankruptcy proceedings have actually commenced, relying on the "...discontinuance of lessee's business". After such a termination, the vessel would not be subject to the jurisdiction of a bankruptcy court,[118] and would therefore not be part of the bankrupt estate.

(2) In the instance of lessor's bankruptcy

117. As a general principle, bankruptcy proceedings affect a leased vessel, since it is considered to be part of the lessor's overall property. However, some jurisdictions do not accept bankruptcy proceedings commenced by a foreign court. Therefore, the legal consequences of bankruptcy proceedings commenced against the lessor are determined by the national bankruptcy law of the lessor's permanent place of residence, as well as by the legal system of the port State.

118. From a lessee's point of view, it is of foremost importance to know the extent to which commencement of bankruptcy proceedings against the lessor may affect the lease agreement. Since there are no internationally unified legal principles governing this question, German bankruptcy law may serve as one example to illustrate this discussion. In accordance with paragraph 21 of the German Bankruptcy Act, the trustee is bound by the lease agreement, provided the vessel has already been delivered to the lessee at the time of commencement of the proceedings. The trustee is not entitled to terminate the contract immediately. Of course both the trustee and the lessee are entitled to cancel the lease agreement in accordance with the contractual stipulations on cancellation. However, not all jurisdictions follow this principle. Therefore, a lessee has to take into account that a lessor's insolvency may also affect the lease agreement.

C. Strengthening the legal positions of both the lessor and the lessee

(1) Proposals for strengthening the lessor's position

119. It appears from the foregoing that, under a ship-leasing contract, a lessor always faces the risk that his interests in the vessel may be affected by claims of creditors of the lessee who furnish supplies, repairs, etc. to the vessel during the lease period. A lessor has only limited ways to protect his interests. He may choose to monitor the trading activities of the lessee, in order to be able to terminate the ship-leasing contract before the situation becomes critical, on the grounds that any discontinuance in the lessee's business activities is to be treated as an event of default under the contract. However, this is not a very practical solution.

120. Therefore, leasing companies are very often interested in creating a first preferred mortgage on the leased vessel, constituting a prior claim to debts not secured by a preferred maritime lien.[119] For this purpose, the leasing company (parent company) establishes a subsidiary company acting as owner of the vessel. The parent company grants a loan to the subsidiary to enable the latter to acquire the vessel. The loan is secured by a first preferred mortgage on the vessel. Finally, the ship-leasing contract is concluded between the subsidiary (as lessor) and the lessee. However, it is not clear that such a practice will be accepted by the courts. In Equilease Corp. v. m/v Samson, a United States court re-

[116] As already cited above, article 14 of Standardlease entitles the lessor to: declare the entire amount of the total rent payable; terminate the contract, and withdraw the vessel.

[117] *Tulane Colloquium*, *op. cit.*, p. 7.

[118] Barnett, *op. cit.*, p. 81.

[119] For a detailed discussion of this practice, see: Barnett, *op. cit.*, pp. 79-81.

ferring to the 1920 Ship Mortgage Act held that:

> "Although the Equilease-Unilease arrangement was not itself illegal, third parties must be protected from suffering financial loss caused by that agreement... Hence, Equilease cannot put itself in ahead of other legitimate creditors by transferring the boat to... controlled corporations and then taking a preferred first mortgage on the vessel, the amount thereof representing capitalization of its investment in those vessels."[120]

121. It is not certain whether courts in other jurisdictions not bound by the United States 1920 Ship Mortgage Act would follow this argument. However, uncertainty has been created in terms of the extent to which a lessor can get actual protection by using the above device.

122. With regard to the potential financial problems arising from the United States Oil Pollution Act, mortgagees' interest pollution risk insurance has been recently and specifically created for this purpose. This type of insurance is designed to protect the lessor's recovery in the event its mortgage is subordinated to pollution damage claims. Brokers also offer insurance designed to protect a lessor from direct claims for pollution damage.[121] The costs for such coverage would be included within lessors total costings when calculating rental requirements.

123. Another way of sharing the risks under a ship-leasing contract is the so-called leverage lease transaction. A leverage lease, sometimes called a "tax-oriented leveraged lease", is a finance lease in which the lessor has himself borrowed the majority of funds to purchase the property to be leased. Thus the purchase price of the vessel is shared between the lessor and at least one other financier. The lessor usually arranges one or more additional independent financiers, with bank loan funding covering as much as 80 per cent or more of the newbuilding or purchase costs.[122] Leveraged lessors are frequently a group of equity participants with potential individual tax advantages (often a big windfall income pushing them into an undesirably high tax bracket) but usually also requiring additional support from a financial institution to have sufficient funds for the proposed purchase and thus realise their target tax savings. In a nutshell, the owner/lessor receives one hundred per cent of the tax savings for financing less than one hundred per cent of the cost (often only a very small proportion of the necessary funds), with the balance of the funds coming from a traditional bank loan to the lessor, or from equity investment by others also seeking tax savings, or a mixture of both.

124. The loan to the lessor is often secured by a first preferred mortgage on the vessel to be repaid out of the lease rental. In this instance, the lessee makes his rental payments directly to the bank holding the mortgage, who then deducts the loan payments and passes the balance on to the lessor. The lessor in turn distributes these earnings among his equity investors, if any. A typical example of such a leasing arrangement is a ship barter transaction where the additional securities, granted by the banks for the purpose of backing the lease, are secured by mortgaging the vessel.[123]

125. A "...leveraged lease transaction will ordinarily involve at least the following documentation: (i) a lease, between the Lessee ... and the owner-trustee who represents the equity participants of the Lessor... , (ii) a trust agreement, between the owner-trustee and the [other] equity participants of the lessor... . This describes the rights of the equity participants and the duties of the owner-trustee who acts as the representative of Lessors... , and (iii) the trust indenture between the owner-trustee representing the Lessor... and the lender of the funds to them."[124]

126. The advantages of ship leasing are combined with a reasonable sharing of the risks facing a lessor under a traditional lease. This system was put together to suit and take advantage of United States tax and finance laws, and in the ship-leasing field can be combined with the Unites States Government Maritime Aid Program, making leverage leasing transactions very attractive for both lessors and lessees.[125] In some countries it may not be possible to combine the factors allowing leverage leasing. In other countries it may be accomplished, with local modifications. In the United States, leveraged leases now account for between 20 and 30 per cent of total leasing volume each year.[126] The

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120 Equilease Corp. v. m.v. "Samson", 568 F. Supp. 1259, E.D. La 1983.

121 Wolfe, *op. cit.*

122 Porter, *op. cit.*, p. 16.

123 See: "New Pepsico-Soviet ship barter deal struck", *Seatrade*, Vol. IX, No. 15, London, 1990, p. 1.

124 *United Nations Analysis*, *op. cit.*, para. 22.

125 H.C. Cook Jnr., "Ship Finance - Leveraged Lease II", *New York Seminar*, *op. cit.* The United States aid comes in the form of "MarAd Title XI" (the law under which finance and construction differential subsidy (CDS) payments are made) which guarantees the leveraged debt. See also: Nevitt, *London Seminar*, *op. cit.*, pp. 41-59.

126 Porter, *op. cit.*, p. 16.

leveraged lease is particularly used to finance larger capital projects, where the risks can not be borne by a single lessor. The acquisition of containerships falls into the category of such projects.

(2) Proposals for strengthening the lessee's position

127. As covered above, virtually all financial leasing contracts offered by banks and financial houses will have a "hell and high water" clause including prohibition from terminating the contract prior to its designated completion. When tax advantages have been obtained by the lessor, whether or not there is an acknowledgement that some or all of these have been passed on to the lessee in the quantum of the rental calculation or, in fact, in any other way, it is extremely difficult to know in advance the "buy-out value" of the contract part way along its course. Estimates may not be accurate, especially as regards potential changes in tax benefits over the extended life of the lease contract. However, should an early termination apply for some reason, the lessor can then calculate his financial position including actual tax advantages and/or obligations to that date. Thus the potential lessee should use all his negotiating strength to build wording into the contract which specifically addresses an option to purchase the vessel, or for its sale to a third party prior to the contracted termination of the contract. He will always have to pay out the lessor's contracted built-in full-term tax savings and profit, and this quantum could easily make it prohibitive to considering termination until the contract is near completion, but the option could be beneficial at some future date. Despite the desires of financiers to maintain a clean, unbroken contract, in this modern world of fluctuating interest rates (and exchange rates), a terminated contract originally made at a lower rate will release funds for the lessor to make a more profitable new contract elsewhere at higher current interest rates, if the money market is moving in that direction.

128. While contractual claims of third parties against the lessor are usually of less impact on the lessee's position, the commencement of bankruptcy proceedings against the lessor may seriously affect the lessee's interests for various reasons. Even a trustee who is bound by the contractual provisions will take every opportunity to cancel the contract as soon as a cancellation is allowed under the ship-leasing contract. Since no insurance covering this risk is available on the market for a reasonable premium, it is difficult for a lessee to protect himself against such risks.

129. A lessee should ask for particular stipulations referring to this risk in the contract and so protect his interests. The particular stipulations always depend on the special interests of the lessee and lessor, which are determined for each ship-lease contract. However, it is always worthwhile for a lessee to ask for at least:

(a) A claim for damages, even if it will realize only a small percentage of the claim, depending on the percentage calculated in the bankruptcy proceedings;

(b) A stipulation granting him a right to cancel the ship-leasing contract; and

(c) A right to buy the vessel at a preferential price, reflecting the fact that the lease rentals have already paid for the vessel.

CHAPTER IV

THE UNIDROIT CONVENTION ON INTERNATIONAL FINANCIAL LEASING, 1988

130. As the use of ship leasing began to spread, it became clear that the fragmentary nature of domestic laws and the unsatisfactory results of the various attempts to force financial leasing into the conventional contractual system marked a lack in the international community of an appropriate legal framework for leasing transactions. This was particularly true as far as cross-border leasing was concerned. The need for internationally unified provisions on financial leasing was recognized, and at the fifty-third session of the UNIDROIT Governing Council in 1975, first priority was given to the subject of financial leasing.[127] The draft uniform rules were prepared by experts drawn from the world of law and business, coming from such diverse legal systems as Brazil, France, Hungary, Italy, Nigeria, Spain, Switzerland, United Kingdom, United States, and Yugoslavia.[128] Nevertheless, it took 13 years until the "Convention on International Financial Leasing" was finally adopted at Ottawa (Canada) in 1988.

131. After lengthy discussions, the Conference decided to extend the scope of application of the Convention to ships. The typical structuring of a ship-leasing deal, covering two contracts (a contract between supplier and lessor and a contract between lessor and lessee) are governed by the Convention, provided that all parties to the leasing deal have their permanent place of business in a Contracting State. The Convention is also applicable if the supply contract as well as the leasing agreement are governed by the national law of a Contracting State.[129] However, the parties are entitled to exclude the application of the Convention.

132. Without analyzing the Convention in detail, it may be stated that the main principles are quite similar to the stipulations of the standard form contracts discussed above. The role of the lessor "...is limited to the injection of the necessary capital for the purpose of the equipment required by the lessee."[130] Consequently, the lessor is relieved of any liability towards the lessee for defects in the equipment (article 8), and the obligations of the supplier under the supply agreement are also owed to the lessee (article). The obligation to maintain the equipment during the lease period is on the lessee (article 9). The Convention even follows, to a large extent, the very harsh sanctions in case of delay in rental payment by the lessee. Article 13 entitles a lessor, in the event of default by the lessee to recover accrued unpaid rentals together with interests and damages;[131] and terminate or to claim accelerated payment of the future rentals,[132] where the breach of contract by the lessee was substantial.

133. Unlike Standardlease, the Convention grants the remedies (termination and acceleration of rental instalments) to the lessor as alternative forms of reacting to an event of default. The lessor is not entitled to terminate the contract nor to claim accelerated payment as is stipulated under Standardlease. The establishment of internationally unified rules is undoubtedly a merit of the Convention. However, it has failed to provide answers to some of the most crucial questions of ship leasing. Two examples may be cited showing that particular aspects of financial leasing in container shipping have not been properly reflected in the Convention. First, article 7 deals with the very important question of the relationship between the lessor and the creditors of the lessee. On the one hand it is stated that the lessor's:

> "... real rights in the equipment shall be valid against the lessee's trustee in bankruptcy and creditors..."[133]

On the other hand, however, the protection granted to the ownership interests under article 7 (1) (a) is taken away from the lessor under article 7 (5), which provides that:

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127 M.J. Stanford, "The UNIDROIT Convention on International Financial Leasing adopted in Ottawa on 26 May, 1988", *World Leasing, op. cit.*, p. 58.

128 *United Nations Analysis, op. cit.*, para. 25.

129 Article 3, para. 1 (b) of the Convention.

130 Stanford, *op. cit.*, p. 62.

131 Article 13 (1).

132 Article 13 (2).

133 Article 7 (1) (a).

"This Article shall not affect the priority of any creditor having ... b. any right of arrest, detention or disposing conferred specifically in relation to ships ... under the law applicable by virtue of the rules of private international law".

134. Under the provision of article 7 (5) of the Convention, any creditor of the lessee whose claim gives rise to a maritime lien or a right to proceed against the ship in an action *in rem*, or a right of arrest[134] is safeguarded against the ownership interests of the lessor. Taking into account that almost all claims by a lessee's creditors give rise to one of those privileges, it is very hard to imagine that article 7 (1) (a) will offer efficient protection to a lessor's ownership interests under a ship-leasing contract.

135. The situation is quite similar under article 8 of the Convention, dealing with the lessor's liability in tort. Article 8 (1) (b) stipulates that:

"... the lessor shall not, in his capacity of lessor, be liable to third parties for death, personal injury or damage to property caused by the equipment".

However, article 8 (1) (c) states that:

"The above provisions shall not govern any liability of the lessor in any other capacity, for example as owner."

136. Since the position of the lessor as registered owner of the vessel can be sufficient to engage his liability in tort to third parties,[135] although the lessee is solely responsible for the operation of the vessel, the protection granted to the lessor under article 8 (1) (b) must be regarded as little comfort, without having any compensating positive effects for the lessor as owner of the leased ship.

137. If the Convention enters into force, it will have only a very limited effect on international ship leasing. The basic concept of the Convention is already reflected in the standard form contracts used for ship leasing. Furthermore, the Convention has failed to deal efficiently with the critical problems which urgently require an international unified solution, such as the safeguarding of the lessor's interest during the operation of the vessel. Consequently, the Convention does not satisfy the demand for unified rules and principles for ship leasing in international law, although its provisions are made applicable to financial leasing in container shipping.

138. However, the provisions of the Convention do not create any serious problems for the parties to ship-leasing contracts. The contractual stipulations of the standard charter parties can be easily adapted to the Convention if the parties wish to apply its provisions to their contracts.

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134 For the list of claims giving rise to a right of arrest see: article 1 (1), and article 3 (4), of the "International Convention for the Unification of Certain Rules Relating to the Arrest of Seagoing Ships, 1952".

135 Under the CLC 1969 the shipowner is held liable for any pollution damage arising out of an oil spill caused by his vessel.